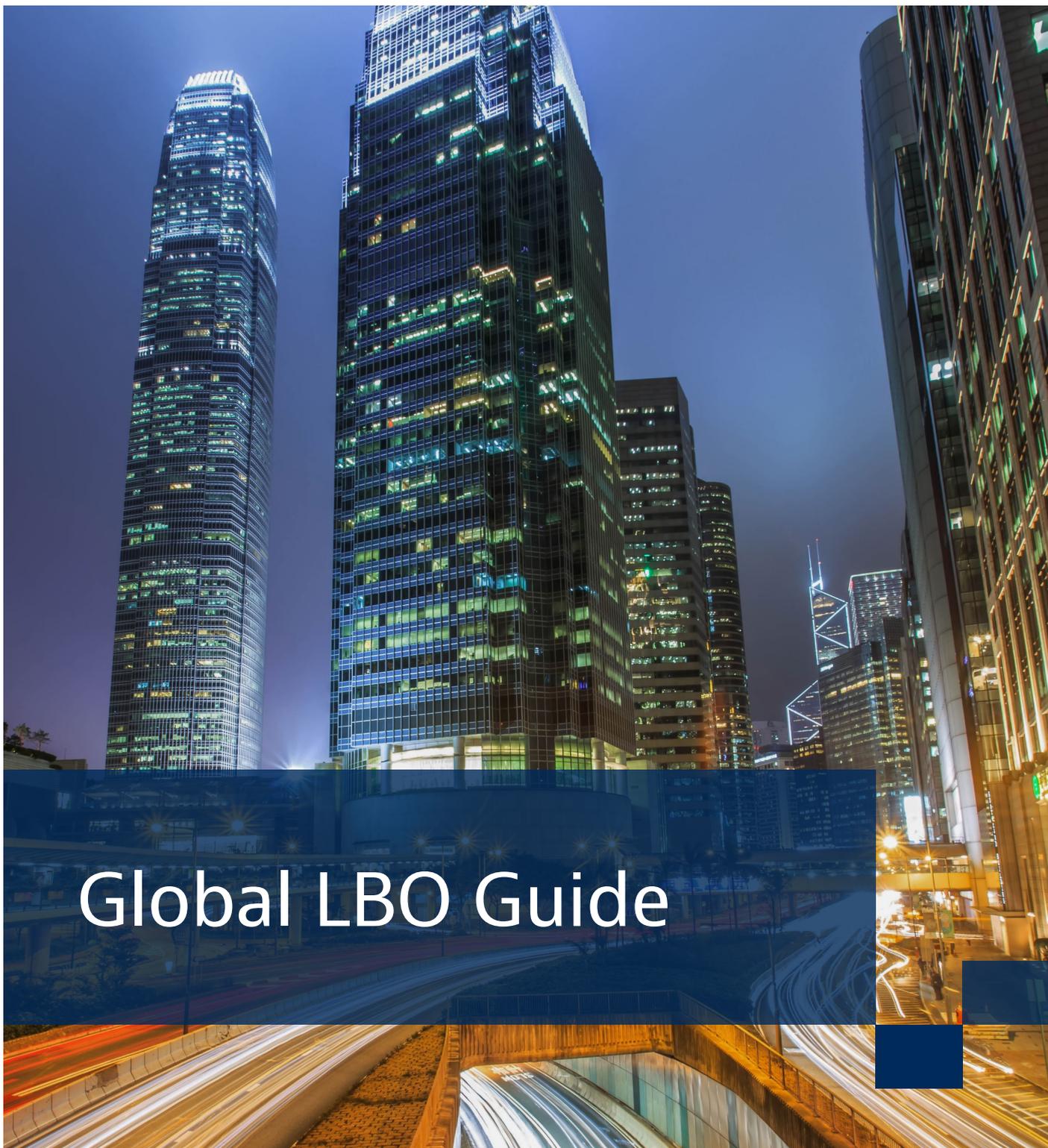


**Baker  
McKenzie.**



# Global LBO Guide



# Global LBO Guide





## Table of Contents

Argentina .....	3
Australia .....	15
Austria .....	30
Brazil .....	43
Canada .....	60
Chile .....	73
Colombia .....	86
Czech Republic .....	101
France .....	116
Germany .....	137
Hong Kong .....	152
Hungary .....	167
Indonesia .....	181
Italy .....	190
Japan .....	208
Luxembourg .....	221
Malaysia .....	235
Mexico .....	245
The Netherlands .....	258
People’s Republic of China .....	274
Peru .....	287
Philippines .....	298
Poland .....	311
Singapore .....	326
Spain .....	337
Sweden .....	353
Switzerland .....	366
Taiwan .....	377
Turkey .....	388
Ukraine .....	403
United Arab Emirates .....	414
United Kingdom .....	422
United States .....	439
Venezuela .....	460





## Foreword

We are pleased to present the second edition of Baker McKenzie's Global LBO Guide. With stronger investment pipelines and corporate balance sheets as well as improved financing accessibility and exit options, private equity firms are pursuing a greater number of targets in more sectors in more markets around the world. Drawing on our experience in all aspects of leveraged buyout transactions, this guide provides an overview of key considerations associated with private equity deal-making and fundraising in 34 jurisdictions.

We are deeply indebted to everyone who has given so generously of their time, talent and expertise in producing this guide. It is the product of numerous contributions from our private equity lawyers across the globe and wouldn't have been possible without their insight and analysis.

Michael Fieweger  
Private Equity Group Chair  
August 2015

## Editors' Note

The editors would like to thank various contributors who made this book possible, including:

Argentina	Gustavo Boruchowicz, Roberto Grane and Francisco Fernandez Rostello
Australia	Lawrence Mendes
Austria	Gerhard Hermann, Wendelin Etmayer and Stephanie Sauer
Brazil	Alexandre Pinto
Canada	Alex Roberts, Peter Clark and Greg McNab
Chile	Jaime Munro, Alberto Maturana and Carlo Perez Arizti
China	Dorothea Koo and Tracy Wut
Colombia	Jaime Trujillo and Ricardo Trejos
Czech Republic	Tomas Skoumal and David Reiterman
France	Alyssa Gallot, Francois-Xavier Naime, and Gonzague Basso
Germany	Nikolaus Reinhuber, Gerald Schumann and Christoph Dachner
Hong Kong	Jason Ng and Michael Horman
Hungary	Viktor Sandor Zorad, Pal Takacs, Eszter Patyi and Simon Barnabas
Indonesia	Mark Innis and Bruce Leishman
Italy	Gianluca Benedetti, Rodolfo La Rosa and Luigi Rizzi
Japan	Chris Hodgens, Ryutaro Oka, Tetsuo Tsujimoto and Gavin Raftery
Luxembourg	Laurent Fessmann, Bertrand Job, Romain Jacques, Ariane Spicq and Celine Reymond
Malaysia	Brian Chia, Andre Gan and Ee Von Teo
Mexico	Erik Gutiérrez-Zuniga
The Netherlands	Kuif Klein Wassink, Heico Reinoud, Juliana Dantas and Laurens Linnewiel
Peru	Oscar Trelles, Liliana Espinosa and Uldarico Ossio
Philippines	Elizabeth Opena
Poland	Tomasz Krzyzowski and Sebastian Ponikowski
Singapore	Kelvin Poa, Alex Tan and Chloe Cheng
Spain	Luis Casals, Rossanna D'Onza, Enrique Valera and Juanjo Corral
Sweden	Anders Fast and Emma Seth
Switzerland	Martin Frey and Timo Leis
Taiwan	Stephen Tan, James Hsiao and Alex Chiang
Turkey	Ismail Esin, Kursun Eren and Gul Incesulu
UAE	Will Seivewright
Ukraine	Olyana Gordiyenko, Viascheslav Yakmychuk and Zoryana Matviychuk
United Kingdom	David Allen and Alexandra Desberg
USA	Mike Fieweger
Venezuela	Carlos Delgado and Pedro Crisafulli

Edited by Christina Wilhelm and Madeleine McDonell

All of the information included in this book is for informational purposes only, and may not reflect the most current legal and regulatory developments. This information is not offered as legal or any other advice on any particular matter. It is not intended to be a substitute for reference to laws, rules, regulations or forms. All laws stated as at 1 March 2015.

The Firm and the contributing authors expressly disclaim all liability to any person in respect of anything, and in respect of the consequences of anything, done or not done wholly or partly in reliance upon the whole or any part of the contents of Baker McKenzie's Global LBO Guide. No client or other reader should act or refrain from acting on the basis of any matter contained in this book without first seeking the appropriate legal or other professional advice on the particular facts and circumstances.



## Argentina

### 1. What structures do private equity funds typically use to manage their funds?

The legal structure most commonly used as a vehicle for private equity funds in Argentina is a foreign limited partnership managed by a general partner with a subsidiary of the foreign limited partnership registered in Argentina. The foreign limited partnership may also create an offshore special purpose vehicle (SPV) in a jurisdiction that has a double taxation treaty with Argentina through which the acquisition can be made.

The structures typically used by private equity fund managers to manage Argentinean funds raised from their investor base are stock corporations (*sociedades anónimas*) (SA) or limited liability companies (*sociedades de responsabilidad limitada*) (SRL).

### 2. Do funds need to be licensed by any regulatory authority to conduct business in Argentina?

Funds do not need to be licensed by any regulatory authority to conduct business in Argentina. However, if a private equity fund intends to publicly offer an investment in the fund in Argentina, it must have a license. Most private equity funds are created offshore and the fund's promoter, principals and manager do not require a license unless they plan to make a public offering of the fund's securities or partnership interests in Argentina.

### 3. Are there any approvals required for investments by foreigners in Argentina and, if so, what is the process?

#### Foreign investment approvals

The Constitution of Argentina, and the Foreign Investments law guarantee equal treatment for local and foreign investors. Generally, and subject to certain requirements for specific sectors (see below), foreign investors are not subject to any government restriction or limitation and may invest in Argentina without prior approval, under the same conditions as investors domiciled within Argentina. Foreign entities that intend to invest in Argentina will not be required to obtain any prior authorization in relation to the proposed investment, nor to register their investment with any specific authority.

Foreign investors may carry out investments in manufacturing, mining, commerce, finance, services, production or any industry related to the exchange of goods and services in the same manner as domestic investors, without obtaining any prior government approvals (other than those also required for national individuals and companies). There are, however, certain restricted industries such as broadcasting. Permission for investment in those industries is decided on a case-by-case basis. Specific regulations may either prohibit foreign investment in a company in a restricted industry or require prior authorization for investment.

Investments may be made in various forms, including:

- (a) foreign currency;
- (b) capital assets;
- (c) the proceeds of other investments;
- (d) proceeds that are subject to repatriation resulting from other investments made in the country;
- (e) capitalization of certain foreign credits; and

- (f) certain intangible assets.

Note that a foreign corporate shareholder must, however, register with the Public Registry of Commerce (**PRC**) as a foreign shareholder to be permitted to hold shares in an Argentine company. (This requirement does not apply to individuals). The foreign company must file certain corporate and accounting documents with the PRC including:

- (a) articles of incorporation and bylaws;
- (b) a board of directors' resolution stating the foreign company's decision to act as a foreign equity holder of an Argentine company;
- (c) a power of attorney appointing legal representatives in Argentina;
- (d) financial statements; and
- (e) a certificate of good standing issued by the appropriate government authority - for the purposes of evidencing its existence and good standing under the laws of the country of its incorporation.

In certain jurisdictions (e.g., in Buenos Aires, the jurisdiction most often chosen by foreign companies for registration), a foreign corporate shareholder must also fulfill additional requirements (e.g., evidence of ownership of non-current assets outside Argentina, identification of shareholders, etc.). Foreign companies incorporated in offshore jurisdictions may face a more cumbersome procedure and stricter scrutiny when seeking registration.

## Exchange controls

It is important to point out that there are exchange control regulations to consider when undertaking a buyout. Flows of foreign currency into and out of Argentina must be registered with the Central Bank of the Republic of Argentina (*Banco Central de la República Argentina*) and settled through the Argentine foreign exchange market on entrance into, and exit from, Argentina. There are also anti money-laundering regulations that must be complied with.

In general, foreign finance is subject to a minimum term of 365 days for the cancellation of the loan. Exchange control regulations designed to prevent speculative foreign capital inflows have established the obligation to make a 30% mandatory deposit for the term of one year with the Argentine financial entity that receives the funds (denominated in USD). This deposit is non-interest bearing and cannot be used as collateral for any transaction.

Among the exemptions to the obligation to make this deposit, exchange control regulations include inflows of capital from equity holders holding at least 10% of the capital stock of the local company to be applied to capital contributions. The regulations also include additional formal requirements such as the simultaneous filing of the capital increase with the PRC and evidence to the local bank of completion of the capital increase registration process with the PRC within 540 calendar days.

## 4. Who are the relevant regulators in Argentina and how much interaction would one generally expect when undertaking a buyout?

The key corporate regulators in Argentina are:

- (a) Central Bank of the Republic of Argentina (*Banco Central de la República Argentina*) which is in charge of the Foreign Investments Registry (*Registro de Inversiones Extranjeras*) and governs exchange control regulations and registration of foreign investments;
- (b) National Securities and Exchange Commission (*Comisión Nacional de Valores*) (**CNV**) which is relevant when acquiring a public entity;



- (c) Public Registry of Commerce (*Registro Público de Comercio*) (**PRC**) which is the regulator for legal entities;
- (d) Federal Tax Authority (*Administración Federal de Ingresos Públicos*) (**AFIP**) which deals with tax implications in relation to acquisitions;
- (e) Antitrust Commission (*Comisión Nacional de Defensa de la Competencia*) (**CNDC**) from which prior approval must be obtained if certain thresholds are met; and
- (f) Secretariat for Industry, Trade and Small and Medium Enterprises (*Secretaría de Industria, Comercio y PyMEs*) that deals with specific regulations applicable to companies depending on the industry involved.

When undertaking a buyout, the expected interaction of the regulators depends on the nature of the transaction, the business or industry of the target, and the parties concerned.

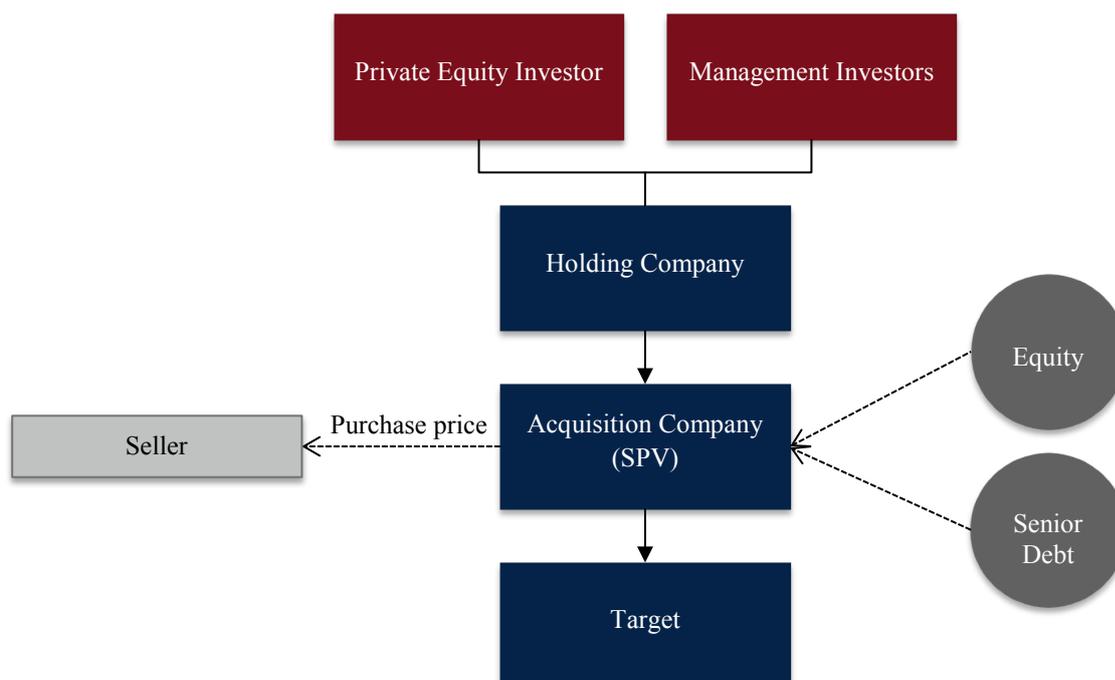
## 5. How are buyouts typically undertaken in the private and the public markets?

In the private market, buyouts are typically undertaken by a negotiated acquisition between the parties. Sale and purchase documents and ancillary documents record the terms of the sale and acquisition and the rights and liabilities of the parties.

In the public market, buyouts are typically undertaken by a public acquisition offer process. This applies to both tender offers and mergers. Any entity intending to launch a public offer bid (even if agreed with the board of the target company) must first obtain the approval of the CNV.

## 6. What is the typical corporate structure used when doing a buyout?

Although acquisitions structures vary, the structure usually adopted when performing a buyout is:



Equity contributions may be injected into either the Acquisition Company or into the holding company (although most commonly the equity contributions are injected into the Acquisition Company).

The holding and/or the acquiring companies may be foreign or local legal entities which will usually be in the form of either an SA or SRL. SAs and SRLs have different corporate requirements. For an SA, the minimum corporate capital amount is ARS 100,000 (approximately USD 11,111 at the current official exchange rate of ARS 9.00 per USD 1) and is represented in shares. The number of shareholders is not limited but must be at least two, and the exclusion of shareholders is not possible from a legal standpoint.

There is no minimum capital amount requirement for an SRL and the capital is represented in quotas. The number of quota-holders must be between two and 50. The legal regime of an SRL is similar to that of an SA. However, an SRL's filing requirements and maintenance expenses are lower. In relation to both types of entities, the equity holders' liability is limited to the subscribed and paid-up shares or quotas.

## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

The following documents are usually prepared:

- (a) letter of intent/memorandum of understanding;
- (b) confidentiality agreement;
- (c) sale and purchase agreement: stock purchase agreement or bulk transfer agreement;
- (d) shareholders agreement;
- (e) services agreements; and
- (f) management agreement.

The sale and purchase agreement and shareholders agreement must be executed in writing and notarized.

Outgoing shareholders notify the board of the transfer of shares and it is recorded in the company's books. For bulk transfers, a prior notification of the share transfer must be published in the Official Gazette.

### Banking

The following documents are usually prepared:

- (a) loan agreement; and
- (b) security agreements including:
  - (i) stock pledge agreement;
  - (ii) surety/bank collateral; and
  - (iii) mortgage agreements and pledge agreements (subject to the regulations of the Argentine provincial jurisdiction where the assets are located).



## 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

When undertaking a buyout, a fund can usually expect buyer protection to be reflected in the sale documents or in ancillary documents and other arrangements including the following:

- (a) non-compete and exclusivity agreements with the seller and key managers;
- (b) escrow/holdback or deferral of purchase price;
- (c) a price adjustment mechanism (common in Argentina); and
- (d) representations, warranties and indemnities.

The amount to be held in escrow/holdback depends on the potential liabilities discovered during the due diligence process. This is therefore decided on a case-by-case basis but an approximate average amount could range from 10% to 30% of the purchase price.

Warranty and indemnity insurance is not used in Argentina.

## 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

Under Argentine law, the term ‘administrator’ refers to directors of SAs and managers of SRLs. Argentine law requires administrators to act in good faith and to abstain from improperly using their position or company information for self-gain or personal benefit (the ‘good businessman’ standard). Administrators who find themselves with a conflict of interest must inform the other members of the board of directors, and refrain from participating in the relevant discussions.

Administrators have joint and several liability for damages suffered by the target company, its shareholders or third parties as a result of disloyal and unfaithful performance (i.e., violation of the good businessman standard), negligence and willful misconduct. However, they could be exempt from any liability if they had no knowledge of the act or omission, or voted against it, disclosed and left the matter on record for the other administrators, and did not carry out the relevant act. Any attempt to limit or exempt administrators from the relevant liability in the bylaws is null and void. Since the main function of the board of directors is to provide governance structure protection to the shareholders, administrators need to analyze those situations in which there may be a conflict of interest, excuse themselves if a conflict arises, and refrain from taking a position that is adverse to the company’s best interests.

Holding one share allows a shareholder to file individual claims against the directors or statutory auditors for non-fulfillment of their corporate duties. An equity holding amounting to at least 5% of the corporate capital enables the holder to oppose the approval of the performance of the directors and statutory auditors as a condition of initiating a corporate liability action against them. Shareholders or quota-holders (as the case may be) approve the performance of managers or directors.

Administrators who remain employed by the target company must also maintain their contractual duties of loyalty, confidentiality and care.

## 10. How the equity arrangements are typically regulated in a buyout?

The equity arrangements in a buyout are typically regulated by means of a shareholders agreement and the bylaws of the company.

Shareholders agreements are enforceable among the shareholders and against the relevant company only if the company itself is a party to it (in which case the board of directors of the relevant company

must comply with its provisions). Shareholders agreements are private documents and do not need to be registered with any public authority.

The bylaws of the company must be approved and registered with the relevant PRC (which will vary depending on the legal domicile of the company). If the bylaws of the company are registered with the PRC, its provisions are enforceable not only against the company but also against third parties. The provisions of the shareholders agreement are reflected in the bylaws of the company to the extent permitted under the Argentine Commercial Companies Law (ACCL). There are certain matters that cannot contradict Argentine law as a matter of public policy and the parties cannot waive them. These matters include the mechanisms to elect directors and the decisions made by the chairman.

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

Under Argentine law, an SA may issue:

- (a) common shares which grant ordinary rights to shareholders, including the right to vote for up to five votes per share, as well as the right to:
  - (i) receive dividends;
  - (ii) negotiate shares;
  - (iii) inspect the records of the company; and
  - (iv) receive assets on liquidation;
- (b) preferred shares which grant their holders specific economic preferences such as:
  - (i) a preferential right to receive reimbursement on liquidation (up to their face value); and
  - (ii) a preferential right to receive special dividends, a percentage on the revenues, and any other economic benefit.

If the bylaws provide for different classes of shares, shares within each class have the same rights. Different classes of shares may grant their holders different rights. Voting preferences are incompatible with economic privileges (i.e., the same class of shares may not grant the shareholder both economic and voting privileges). However, in certain scenarios (e.g., in the case of the anticipated dissolution of the company, transfer of the company's domicile abroad, or a substantial change of the corporate purpose when the company is in arrears in relation to the payment of granted privileges) the holders of preferred shares are entitled to vote. In any event, they can always attend shareholders' meetings, voice their opinion and leave on record any eventual opposition (even if not permitted to vote).

If a company is regulated (e.g., because its shares are listed or it has issued securities under public offerings), the issue of a preferred share requires prior clearance from the CNV. Note also that once an SA has been listed, it may no longer issue shares with voting privileges.

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

### Board constituency

An SA must have a board of directors composed of at least one member and an equal or lesser number of alternates, if no statutory auditor is appointed. In the case of public companies or when the corporate capital exceeds a threshold of ARS 10 million (approximately USD 1,130,000), however,



the number of directors must be at least three and a supervisory committee must be appointed. Directors do not need to be shareholders.

A listed company must have a board of directors (composed of at least three directors) and a supervisory committee. Supervisory committees have specific obligations set out in the ACCL, which include, among other things, to:

- (a) audit the administration of the company;
- (b) assist the board of directors' meetings; and
- (c) prepare and deliver an audit report in relation to the economic situation of the company for the shareholders.

The chairman of the board of directors is the legal representative of the company and is permitted to perform all activities in relation to the corporate purpose. The chairman may be awarded a casting vote in the event of a tie in the vote of a matter at issue (and a provision to this effect ought to be included in the bylaws). In principle, the powers of the board of directors can be freely determined in the bylaws and unless there are express limitations contained in the bylaws, the law presumes that the directors have all necessary authorities to carry out the corporate purpose and manage the company on a daily basis.

Directors may be Argentine or foreigners, but the majority of the board of directors must be Argentine residents.

### Appointment and removal of directors

The board of directors may appoint officers, whether directors or not, to whom they may delegate the executive functions of management. If different classes of shares exist, the bylaws can provide for a director to be appointed to represent each class of shares. In that case, removal of a director who represents a class of shares must be effected by a resolution by the shareholders who own the corresponding class of shares.

Directors may be removed with or without cause and no provision in the bylaws can provide otherwise. In the case of SAs, three years is the maximum term for directors (including if appointed by the supervisory committee). The term may be renewed at the end of the three-year period.

In the case of an SRL, the partners (quota-holders) can manage the company, but in most cases, this is delegated to managers appointed by the partners. Corporations cannot be quotaholders of SRLs. The residency requirements that apply to directors also apply to managers. Managers can hold office for a limited or unlimited term, as set out in the bylaws. Removal cannot be limited unless the appointment of the relevant manager to be removed was an express condition of the setting up of the SRL.

### Differential director voting rights

Differential director voting rights and appointment and removal rights are typically included in the shareholders agreement, although any provision in the bylaws completely blocking the right of removal of directors is not valid.

### 13. What measures are commonly used to give a fund some level of control over key operating and financial decisions made by a portfolio company?

The most commonly used measures to give a fund some level of control over key operating and financial decisions made by a portfolio company is a shareholders agreement which can include the following:

- (a) a special quorum majority at the board of directors' or the shareholders' meetings;
- (b) a special voting majority for certain strategic resolutions to be approved by the board of directors or the shareholders;
- (c) veto rights for certain strategic decisions to be approved by the shareholders;
- (d) a majority on the board of directors;
- (e) the appointment of key personnel to manage the company;
- (f) a casting vote in the board of directors' meetings; and
- (g) reporting requirements (e.g., periodic financial reports and the right to inspect corporate books and records).

These provisions may also be reflected in the bylaws of the company. Although they do not need to be included in the bylaws of the company to be enforceable it is recommended (although, if they are incompatible with the ACCL, they would not be enforceable). Whether or not any of the rights listed above would be incompatible with the ACCL would depend on the exact content of each right included in the bylaws. To avoid any issues they would need to be carefully structured to comply with the ACCL.

Rights included in the shareholders agreement are enforceable among the parties as long they do not contravene Argentine law. Companies are commonly party to the shareholders agreement, usually represented by their presidents.

### 14. What employment terms are generally imposed on management in a buyout?

In a buyout, senior members of management usually enter into an employment agreement with the acquiring company. These agreements may provide for an incentive not to leave the company. Non-competition provisions may also be included in these agreements. The duty not to compete or engage in any unfair competition during the course of the employment is the duty of loyalty set out in the Argentine Employment Contract Law. After the termination of the employment relationship, agreements not to compete with the employer are also acceptable if they are executed or ratified by the employee after the termination of the employment relationship, are limited to a fixed term and a reasonable consideration is paid. A fee may be provided as an incentive to ratify.

Employment agreements may include a fixed component and a bonus component related to performance. Finally, under the acquired rights rule, these agreements may not reduce or suppress the terms and conditions of the employment relationship (i.e., remuneration) the employee had with the previous employer.



## 15. What equity incentives can be offered to management and how are they typically structured?

Incentives offered for management are generally based on securities (shares and share options) as well as bonus structures (based on the company's financial development or individual goals). They can also be structured on a long-term basis or a short-term incentive based on the annual results. If the fund decides to take the company public, stock options are a typical incentive to consider.

The amount of this equity incentive would be part of the total compensation package provided by the company.

## 16. How are buyouts typically debt financed and secured?

Buyouts are typically debt financed by Argentine banks, foreign banks and investment funds. When lending or borrowing foreign currency, the financing will need to be carefully structured to ensure that it complies with exchange control regulations (refer to the answer to question 3).

Buyouts are usually secured by a pledge over shares, banking guarantees, sureties, mortgages and other pledges subject to the regulations of each Argentine provincial jurisdiction where assets are located.

## 17. Are there financial assistance issues to consider when undertaking a buyout?

Target company may acquire shares on certain terms and conditions

There is no express prohibition on a company incorporated in Argentina providing financial assistance in connection with the acquisition of shares in itself or its parent company. Under Argentine law, however, a target company may only acquire its own shares:

- (a) to cancel them, if there has been a prior decision to reduce the company's capital;
- (b) exceptionally, with liquidated profits or free reserves if the shares are entirely paid-up, and to avoid serious damage, which must be justified at the next shareholders' meeting; or
- (c) if those shares are part of a bulk transfer (*fondo de comercio*) acquisition by a third party company and/or part of a company that is merged into the acquiring company.

### Court challenges

Notwithstanding the fact that buyouts involving the giving of financial assistance have occurred in Argentina, some of these have been challenged in court, with allegations of fraud by the creditors of the target company. The challenges to this type of transaction arise on the insolvency of the acquired company. The allegations are based on the ground that buyouts involving financial assistance transfer the financing of the transaction to the target company, exposing its assets (which are usually encumbered in favor of the creditors that have financed the buyout) and prejudicing the target company's other creditors and third parties.

In certain transactions involving financial assistance, courts have ruled that they violate the following provisions of the ACCL:

- (a) the administrator's duties of loyalty and care;
- (b) the restriction on companies giving financial assistance in connection with the acquisition of their own shares;
- (c) the use of the corporate structure for non-corporate purposes;

- (d) the administrator's improper use of his/her position or company information for his/her self-gain (personal benefit); and
- (e) the administrator's duty of refraining from participating in a discussion in relation to a particular matter, if there is a conflict of interest with the company.

## 18. What are the implications under the corporate benefit laws of Argentina for a company providing financial assistance?

As stated in the answer to question 17, the challenges to transactions that involve the giving of financial assistance arise on the insolvency of the acquired company. In certain cases, courts have alleged that buyouts, in which financial assistance had been used, violate certain provisions of the ACCL. Therefore, a transaction involving the giving of financial assistance may be declared null by the courts.

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

According to Argentine law, basically there are two types of creditors — secured and unsecured. In turn, secured creditors can have either special preference or general preference.

Secured creditors with special preference are:

- (a) those with claims for expenses relating to the conservation, administration and liquidation of the security assets (e.g., legal fees of the statutory auditor);
- (b) creditors in possession of a particular asset that belongs to the debtor and who have a right to withhold that asset;
- (c) employee claims for salaries for the last six months;
- (d) employee claims for damages that have arisen out of workplace accidents or in relation to severance payments;
- (e) those with claims for taxes and contributions in relation to a specific asset;
- (f) those with claims secured by a mortgage, pledge or warrants; and
- (g) bondholders secured with a special or a non-identified asset.

Secured creditors with special preference are entitled to collect their claims out of the proceeds of the sale of the asset on which their security is set.

Secured creditors with general preference are:

- (a) (in addition to the special preference listed above), employee claims for damages arisen that have arisen out of workplace accidents or in relation to severance payments;
- (b) those with vacation payments or any other amount due by the debtor company as a result of the employer/employee relationship;
- (c) those with social security and unemployment insurance claims;
- (d) those with general tax claims not specifically relating to an asset; and
- (e) those with claims backed with expressly accepted invoices up to the amount of ARD 20,000 (approximately USD 2,222 at the current official exchange rate).



Secured creditors with general preference are entitled to collect their claims from the debtor's assets only after all secured creditors with special preference have been paid.

Once all secured creditors, either with special preference or with general preference, are paid, unsecured creditors are entitled to collect their claims. All creditors are paid out within each category on a *pro rata* basis.

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

### Overall tax treatment of structure

When setting up the corporate structure to implement a fund, it is necessary to evaluate the Argentine as well as the non-Argentine tax implications.

In relation to non-Argentine tax implications, SRLs are considered pass-through entities for U.S. tax purposes if the corresponding election is made with the U.S. Internal Revenue Service.

In relation to the Argentine tax implications, the most significant tax impact derives from Argentine income tax. In this respect, it is not advisable for the foreign owners of Argentine companies to be legal entities or other types of vehicles incorporated in jurisdictions considered as non-cooperators for fiscal transparency purposes (i.e., tax haven jurisdictions) due to the fact that they are subject to adverse tax implications in Argentina. There is a specific list of these countries prepared by the AFIP. The analysis below assumes that, where Argentine companies are owned by foreign legal entities or other types of vehicles, they are not organized in jurisdictions deemed to be non-cooperators for fiscal transparency purposes.

### Transfer taxes

Share purchases within the jurisdiction of the City of Buenos Aires are subject to stamp tax at the rate of 1% on the 'economic value' of the transaction. Share purchase agreements with effect in other provinces are subject to stamp tax of approximately 1.5% (the rate varies depending on each jurisdiction).

Further, the City of Buenos Aires levies a stamp tax on real estate transfers of 3.6%. In other provinces, rates may differ. The stamp tax is a local tax that is normally triggered when land registration documentation is created or amended during a transfer of land or where rights or obligations relating to land are amended or extinguished. Notary fees and costs are also payable on transfers of real estate, at variable, negotiable rates, but capped at approximately 2.3% of the value of the land.

### Dividends

Dividends in cash or in kind paid by Argentine companies to individuals residing in Argentina, undivided estates of deceased persons located in Argentina and foreign beneficiaries are subject to income tax at the rate of 10%. In addition, profits in cash or in kind paid by Argentine branches of foreign companies are subject to income tax at the rate of 10%. This 10% must be withheld by the Argentine entity that pays dividends on distribution.

### Income tax consequences on exit

The sale of shares of an SA or the sale of quotas of an SRL by a non-Argentine shareholder (whether the non-Argentine shareholder is an individual or a legal entity) is currently subject to income tax at a rate of 13.5% on the gross amount paid or, alternatively at the option of the taxpayer, 15% on the actual net income arising from the sale of shares. (An Argentine seller would pay 15% income tax on the sale of shares or quotas, as the case may be.)

On the transfer of shares or quotas, the buyer must report and pay the income tax arising from that transaction to the AFIP. Currently there is no mechanism for reporting and paying the income tax withheld when the buyer is a foreign entity, although it is anticipated that the AFIP will implement a payment mechanism for this purpose in the near future.

If the sale of shares or the sale of quotas of an SRL is performed by an Argentine corporate shareholder, the capital gains arising from the sale will be taxed at a rate of 35%.

### Deductibility of interest and financing costs

The AFIP has consistently disallowed the deduction of interest deriving from loans granted to an Argentine borrower to fund the acquisition of an Argentine company. Also, interest to be paid by an Argentine borrower to a non-Argentine lender is subject to income tax withholdings at the rate of 15.05% (if it qualifies as set out below, or a 35% withholding rate in all other cases).

The 15.05% rate applies subject to the following conditions:

- (a) the borrower must be an Argentine financial entity or an Argentine individual or legal entity; and
- (b) the lender must be a banking or financial entity, subject to supervision by a specific banking supervising authority, which is:
  - (i) not incorporated in a jurisdiction deemed as a ‘non-cooperation jurisdiction’ for fiscal transparency purposes; or
  - (ii) incorporated in a country which has executed a treaty to exchange information with Argentina.

Tax rates may be reduced under the specific benefits granted by the tax treaties executed by Argentina with other countries to avoid double taxation.

## 21. What forms of exit are available?

In a solvent situation, the most common forms of exit are an IPO and a trade sale (a sale of shares or a sale of the underlying business/assets).

In an insolvent situation, Argentine Bankruptcy Law does not deprive the shareholders of a bankrupt company of ownership of their stock. Shareholders of a bankrupt company may keep or sell their stock at their discretion. In the case of reorganization proceedings (similar to Chapter 11 in the U.S.), shareholders of the debtor company may be forced to sell their shares if the ‘cramdown process’ is launched within the reorganization proceedings. The ‘cram down’ process starts if the required majority of creditors do not approve the reorganization plan. In those circumstances, a third party may be entitled to buy out the debtor company’s shares by undertaking payment of its debt. Shareholders may receive, as consideration for their shares, the value determined by the experts appointed by the Court.



## Australia

### 1. What structures do private equity funds typically use to manage their funds?

Two structures are commonly used by private equity funds to manage Australian funds raised from their investor base as follows:

- (a) a parallel unit trust structure. The investors hold units in two parallel trusts. The trusts are considered to be ‘transparent’ for tax purposes provided they are not treated as public unit trusts.
- (b) a limited partnership structure. The investors hold limited partnership interests in the partnership and the general partner controls the partnership and its operations. Due to certain tax exemptions and concessions focused towards Australian venture capital investing, this structure has become more popular. Like a unit trust structure, a limited partnership is also transparent for tax purposes.

It is not uncommon for many of the larger Australian private equity funds with foreign investors to have both structures available within the one overall fund structure. How investors ultimately invest their funds on any investment depends on whether foreign investors can use the tax concessions available via a limited partnership. If foreign investors in a fund cannot invest via a limited partnership they usually invest via a foreign entity that is tax transparent in its home jurisdiction.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in Australia?

Any entity that carries on business in Australia, including the general partners, managers, trustees and appointed advisers, almost invariably need to be licensed under the financial services regime administered by the Australian Securities and Investment Commission (ASIC), or benefit from a relevant exemption. Licensing requires, among other things:

- (a) demonstrated experience, expertise and qualifications of key personnel of the relevant license holder;
- (b) regulatory capital requirements (generally a minimum of AUD 50,000); and
- (c) implementation of various compliance, training and risk management programs.

In many instances, businesses can circumvent the need to obtain a financial services license by contracting for another licensee to provide financial services as an agent on its behalf. This may have taxation implications, however, and specific advice should be sought before entering into this type of arrangement.

The relevant laws and regulations also provide for a number of specific exemptions from the need to be licensed, including if:

- (a) an entity relies on another licensee’s license (i.e., in circumstances where the licensee has appointed the entity as an authorized representative and takes responsibility for their representative’s conduct (e.g., fund marketing, dealing or advisory activities));
- (b) the only activity the offshore provider engages in, in relation to Australia, is conduct intended, or likely, to induce people in Australia to acquire an interest in a financial product or use a financial service, and all other activities occur offshore;
- (c) the financial product advice or dealing services are provided by an offshore provider to Australian wholesale or sophisticated clients only, and the offshore provider is regulated by

an overseas regulatory authority that ASIC considers to be ‘sufficiently’ robust in its regulation (for example, the Securities Exchange Commission in the US, the Financial Services Authority in the UK, the Monetary Authority of Singapore, the Securities and Futures Commission in Hong Kong and the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin) of Germany); and

- (d) the offshore provider does not actively solicit persons in Australia in relation to the financial products.

### 3. Are there any approvals required for investments by foreigners in Australia and, if so, what is the process?

#### Foreign investment notification and consent requirements

Under the *Foreign Acquisitions and Takeovers Act 1975* (Cth) (**FATA**), ‘foreign persons’ (including foreign corporations) may be required to notify and obtain the consent of the Commonwealth Treasurer of Australia (**Treasurer**) to, either alone or together with associates:

- (a) acquire a ‘substantial interest’ in an Australian company or business that is valued above AUD 248 million (indexed annually); or
- (b) implement a takeover for an offshore company that has Australian subsidiaries or assets valued above AUD 248 million (indexed annually).

A ‘substantial interest’ is acquired when a single person (and any associates) acquires 15% or more of an Australian company, or when two or more persons (and any associates) acquire 40% of an Australian company.

In the majority of industry sectors (excluding the sensitive industry sectors discussed below) smaller proposals are exempt from notification and larger proposals are approved unless certain valuation thresholds are exceeded and the transaction is judged to be contrary to the national interest. Special rules apply to the direct or indirect acquisition of different types of Australian real estate.

#### FIRB approval

In addition to the thresholds described above, Australia’s Foreign Investment Policy (**Policy**) provides that prior approval from the Foreign Investment Review Board (**FIRB**) must be sought for:

- (a) investments of 5% or more in the media sector regardless of size; and
- (b) certain investments by foreign government investors (i.e., any ‘direct investment’ in an Australian corporation, proposing to establish a new business or acquiring an interest in land, regardless of the value of the investment). A ‘direct investment’ includes:
  - (i) any acquisition of 10% or more of an existing business; and
  - (ii) any acquisition of less than 10% if the foreign acquiring entity can use the investment to influence or control the target (e.g., if the acquiring entity is given preferential, special or veto rights, or has the right to appoint directors).

In summary, if the value of the gross assets of the target is greater than AUD 248 million, consent must be obtained from the Treasurer. This valuation threshold is raised to AUD 1,078 million if the investment is to be made by certain individuals or entities from the U.S. or New Zealand by virtue of the Free Trade Agreement between Australia and the U.S. and the Protocol on Investment to the Australia-New Zealand Closer Economic Relations Trade Agreement.



Failure to obtain consent for a prescribed investment is an offence under FATA and may lead to the Treasurer making a divestiture order. This type of order requires the buyer to dispose of the assets acquired within a stipulated period of time.

### Application and approval process

An application generally contains background information in relation to the target, buyer and seller (including details of the major business activities, business locations, group ownership structures and the most recent financial statements), the nature of the proposed acquisition, a statement of the buyer's intentions and, if the acquisition is in an area deemed to be sensitive in terms of the national interest, an outline of the benefits of the proposed acquisition for Australia.

Broadly speaking, if a financial threshold is exceeded, the Treasurer will determine if the proposed transaction is contrary to the 'national interest' by having regard to community concerns, and will generally consider if (among other things):

- (a) the foreign investment proposal would lead directly or indirectly to net economic benefits for Australia; and
- (b) after the acquisition, the business will continue to follow practices consistent with Australia's interests.

The Treasurer will usually, in accordance with the requirements of FATA, make a decision within 30 days of receiving an application, and notify the applicant of that decision within 10 days. Generally, if the Treasurer has not responded within 40 days of being notified of a proposed foreign investment, consent is deemed to have been given. It would only be in exceptional circumstances that consent would be denied or that an interim order would be made by the Treasurer to extend the period of time for considering an application by 90 days. However, consent may be given subject to any conditions that the Treasurer considers necessary.

### Industry-specific regulation

Specific restrictions apply to foreign investment in sensitive industries, which include banking, shipping, civil aviation, airports and media and telecommunications. The Treasurer has published guidelines for investment in these industries that should be carefully considered when planning an investment.

## 4. Who are the relevant regulators in Australia and how much interaction would one generally expect when undertaking a buyout?

The primary regulatory authorities in Australia in a corporate context are:

- (a) the Australian Securities and Investment Commission (**ASIC**) – the primary regulator of corporate and financial services laws;
- (b) the Australian Stock Exchange (**ASX**) – the major stock exchange in Australia that provides additional regulation for ASX listed entities;
- (c) the Australian Competition and Consumer Commission (**ACCC**) – the competition/antitrust regulator;
- (d) the Australian Taxation Office (**ATO**) – the taxation authority; and
- (e) the Foreign Investment Review Board (**FIRB**) – the department of Federal Treasury dealing with foreign investment approvals.

The level of expected involvement with ASIC and ASX in a buyout situation largely depends on whether the transaction is being undertaken in relation to a publicly listed company (i.e., a public

takeover or scheme of arrangement). In these cases, interaction is generally higher than when a transaction is a private acquisition.

Interaction with the other authorities largely depends on the nature of the transaction (e.g., which sectors are involved or whether it involves competition/antitrust issues) and the parties concerned (e.g., whether the acquirer is a foreign party).

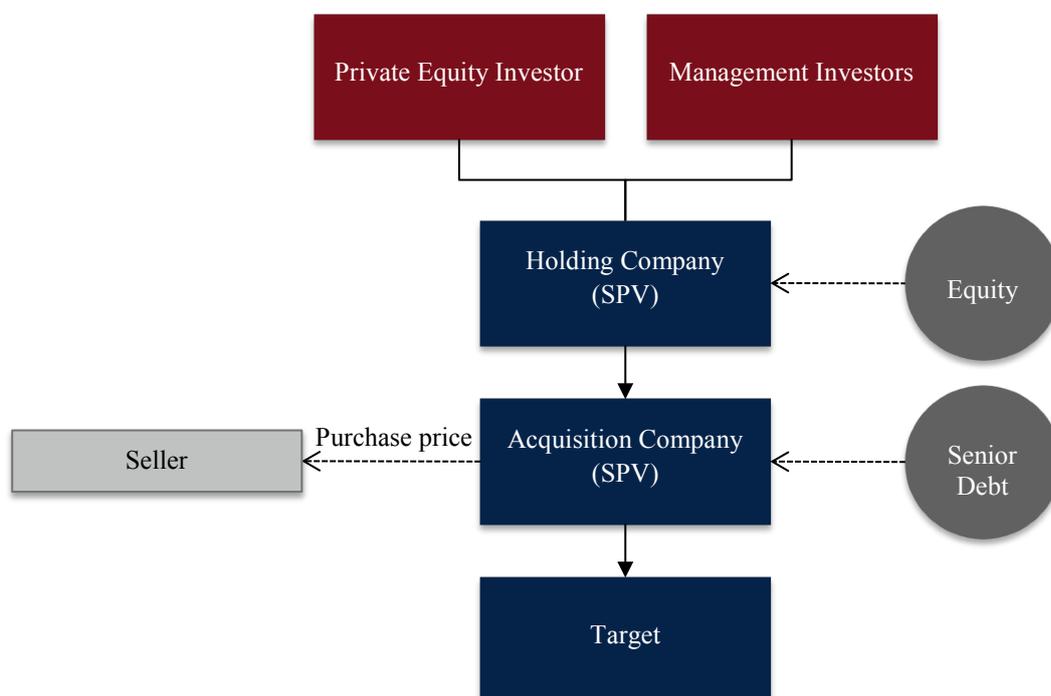
## 5. How are buyouts typically undertaken in the private and the public markets?

In a private context, transactions are usually undertaken by way of negotiated acquisition. That is, negotiated sale and purchase documents are prepared, negotiated and executed and those documents record the terms of the sale and acquisition and the rights and liabilities of the parties.

In the public context, buyouts are generally concluded either by way of a takeover bid<sup>1</sup> or by way of a scheme of arrangement. Both forms of acquisition are regulated under the *Corporations Act 2001* (Cth) (**Corporations Act**) and both provide a means for the acquirer to achieve 100% control of the relevant corporation if certain thresholds are satisfied.

## 6. What is the typical corporate structure used when doing a buyout?

Although acquisition structures do vary from transaction to transaction, it is fairly common to see a two-level holding company structure adopted along the following lines:



This type of structure allows for the senior debt finance to be provided to the Acquisition Company SPV, while the equity contribution from the private equity fund or funds is contributed at the Holding Company SPV level and subsequently contributed down to the Acquisition Company SPV in the form

<sup>1</sup> This can occur ‘on market’ (essentially being conducted as a cash bid via a broker who stands in the ASX trading market to acquire shares at the bid price) or ‘off market’ (where the offer is made and can be accepted by individual target shareholder as a simple matter of contract). In the vast majority of cases off market bids are the preferred form of bid.



of unsecured loan funds or equity. More elaborate structures invariably exist in relation to larger more complex deals, particularly where any debt funding involves mezzanine funding sources that may need to be structurally subordinated to the senior financiers but rank ahead of any equity contributed by the private equity fund or funds.

## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

#### *Private context*

For a buyout negotiated in a private context, the primary legal document that records the transaction is invariably the sale and purchase agreement. There may also be other ancillary transaction documents prepared depending on the nature of the deal. These can include a tax indemnity deed and a transition/shared services agreement.

#### *Public context*

For a buyout in a public context the documentation to be prepared depends on whether the transaction is undertaken as a takeover bid or a scheme of arrangement.

In a takeover, the primary document for the bidder is a bidder's statement. This includes certain prescribed disclosures, together with the terms of the offer by the bidder and may be supplemented through the course of the bid period. The primary document for the target company is a target's statement and must include certain prescribed disclosures in response to the bidder's statement (and it may also be supplemented through the course of the bid period).

In a scheme, the primary document negotiated between the bidder and the target company is an implementation agreement. This records the agreement of the parties to implement the scheme and the terms on which they have agreed to do so (including any conditionality). The implementation agreement also includes the agreed form of certain other key scheme documents, being the scheme rules and a scheme deed poll to be given by the bidder in favor of target stakeholders participating in the scheme. In due course the other critical document to be prepared by the target company is a scheme booklet to be sent to target stakeholders participating in the scheme. This sets out relevant information in relation to the scheme and its terms and notices of meeting with respect to the scheme meetings to be convened.

### Banking

#### *Lending*

The main banking document is the senior facilities agreement that documents the senior debt facilities (typically amortizing and non-amortizing term loans with working capital lines and in some instances capital expenditure or acquisition facilities).

If there is subordinated or mezzanine debt (the terms are interchangeable in the Australian market), there is typically a separate facility agreement under which that debt is made available. If subordinated or mezzanine debt is secured by the same assets that secure the senior debt, the parties also typically enter into an intercreditor or subordination deed recording the respective rights of the senior and subordinated/mezzanine lenders.

#### *Security*

Security is usually held by a security trustee for the senior lenders and, if the subordinated debt is secured on an all asset basis, the subordinated lenders.

Security typically comprises a general security agreement under which a security interest is granted in favor of the secured party over all of the present and future assets of the grantor (equivalent to a fixed and floating charge) and/or a specific security agreement (equivalent to a fixed charge) under which a security interest is granted in favor of the secured party over specific assets such as shares. Mortgages of real estate may also be granted.

#### *Other*

Upfront fees are usually recorded in a separate letter rather than in the facilities agreement.

Hedging is generally documented in a 2002 ISDA (International Swaps and Derivatives Association) multi-currency master agreement.

### **8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?**

In a private context, buyer protections usually take the form of negotiated warranty and indemnity coverage from the seller (being either the shareholders in a share sale or the company from which the business and assets are being acquired). The terms of that coverage vary from transaction to transaction. It is quite normal however to expect that limits will be placed in relation to any coverage of this type, including claim thresholds and caps, time limits and adjustments for items otherwise disclosed or accounted for. More recently, buyers have also been seeking warranty and indemnity insurance or placing a portion of the sale proceeds in escrow for a period.

In a public context the level of buyer protection which can be obtained is less than in a private context. The primary form of protection usually takes the form of conditions precedent to the acquisition that either need to be satisfied or not triggered. Warranty protection from target shareholders is very limited and generally only extends to confirmation regarding unencumbered title and due authority to sell.

### **9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?**

Specific laws do not currently exist regulating how conflicts are managed in a management buyout. The Corporations Act does impose certain general statutory obligations on directors and officers of a corporation not to:

- (a) misuse their positions;
- (b) improperly use information of the corporation; or
- (c) to advantage themselves.

Additionally, general fiduciary obligations dictate that directors and officers must not place themselves in a position of conflict.

Common practice for buyouts in Australia generally sees members of the management team who participate in the buyout quarantined from any board discussion and decision-making concerning the buyout. It is also not unusual for management, and sometimes the private equity fund, to execute a management protocol setting down certain agreed protocols for the management of information flow and other key interactions during the buyout, so as not to disadvantage the seller. The Australian Takeovers Panel has also recommended that an independent committee of the board be established to oversee the application of those protocols and the sale process in the interests of the seller.



## 10. How are the equity arrangements typically regulated in a buyout?

The equity arrangements in a typical buyout are regulated primarily by a shareholders agreement. Additionally, the relevant company's constitution includes specific share rights attaching to the relevant classes of security to be issued.

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

There is a great deal of flexibility under Australian law regarding the types of equity security that can be issued and the level of rights tailoring that can occur. It is common to see different classes of security issued to management and the private equity fund in a buyout.

Rules exist in relation to the issue of redeemable preference shares and the sources of funding that can be used to redeem redeemable preference shares. Further, it is not possible to convert a preference share into a redeemable preference share after its issue date. Generally speaking, neither of these constraints creates any real impediment to equity structuring.

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

Australian proprietary companies (i.e., private companies) must have at least one director who ordinarily resides in Australia. Public companies must have at least three directors, at least two of whom must ordinarily reside in Australia. All directors must be natural persons.

Generally, subject to the above requirements, issues regarding board constituency, differential director voting rights and the removal of directors are all governed in the relevant shareholders agreement. It is common for private equity funds to have specific appointment and removal rights in relation to a certain number of directors of their portfolio companies and for their voting rights to be aggregated if a director is absent from a meeting.

## 13. What measures are commonly used to give a private equity fund some level of control over key operating and financial decisions made by a portfolio company?

Control over key operating and financial decisions made by a portfolio company is generally obtained via the shareholders agreement and is common place. It is effected by the private equity fund having, under the shareholders agreement:

- (a) the right to appoint one or more directors to the holding company (Topco) in the group and also reserving (but not always exercising) the right to have representation on the board of the portfolio company;
- (b) certain rights to receive financial and operating information in relation to the portfolio company to be provided by the managers on a regular basis to enable the private equity fund to closely monitor the performance of its investment. Funds normally also have the right to appoint their own investigating accountant, particularly where there are concerns about the financial performance of the portfolio company or any irregularities that have arisen; and
- (c) specific consent or veto rights over particular decisions of the portfolio company, including decisions that relate to material operating or financial matters.

## 14. What employment terms are generally imposed on management in a buyout?

It is common for senior members of a management team in a buyout to enter into an executive services agreement. Generally speaking this type of agreement does not provide any fixed employment period, but includes provisions dealing with the period of notice that must be given before the employment can be terminated. This period is a matter of negotiation and commonly varies depending on the seniority of the relevant manager. It is also common for remuneration under these agreements to include a fixed component and a bonus component referable to performance.

The executive services agreement also usually contains the following key terms:

- (a) whole time and effort clauses requiring a manager to devote 100% of his or her time to running the target company business;
- (b) non-compete and confidentiality provisions to prevent a manager from competing with the target business and soliciting its customers and key employees for a period of time after the end of the employment; and
- (c) gardening leave provisions allowing for a departing manager to be put on leave during his or her notice period.

Equity incentives offered to management are almost invariably covered in the shareholders agreement rather than the executive services agreement.

Additionally, if a key employee also holds equity in the portfolio company, he or she is usually required to sell or transfer those shares. Please refer to the answer to question 15 for further details in relation to these arrangements.

## 15. What equity incentives can be offered to management and how are they typically structured?

There is a great deal of flexibility in relation to the incentives that can be offered to management.

These incentives generally take the form of ordinary equity or options over ordinary equity. It is also possible to create forms of phantom equity, but careful planning of phantom equity plans is required. Management is expected to pay for its equity, although by reason of the leverage provided by the private equity fund, the contribution rate for its capital is often preferred over the rate contributed by the private equity fund.

Sometimes management may be offered a ratchet in relation to equity which operates to give management a greater overall return if the investment for the private equity fund outperforms certain base return thresholds, usually measured by reference to the fund's internal rate of return on the investment or an absolute money multiple. Generally these ratchets will only crystallize once the fund has achieved a full exit of its investment.

In certain cases, management equity plans are adopted to regulate the way in which management equity is issued (which can include earning or vesting of the equity over a period subject to achievement of agreed financial hurdles) and can be reacquired by the portfolio company if a manager ceases to be employed for any reason. Good leaver and bad leaver provisions are very common, either in the shareholders agreement or in the terms of the relevant plan, and effectively give the portfolio company, or its other shareholders, the right to acquire the equity at a pre-determined price, or in accordance with an agreed price calculation or discount, in a leaver situation.

A good leaver is generally a manager who retires through death, ill health or (in some cases) is made redundant or terminated other than for cause. In these cases, the manager is typically entitled to



receive fair market value for his or her shares. A bad leaver, on the other hand, is typically only entitled to receive the lower of the original acquisition cost and market value for his or her shares.

## 16. How are buyouts typically debt financed and secured?

### Financing

While it varies from transaction to transaction, in the current market typically 40-60% of the cost of an acquisition is provided from debt provided by banks and financial institutions. The amount of debt that can be raised is typically calculated as a multiple of the earnings of the target business. Australia has a large number of domestic and international banks and financial institutions willing to participate in leveraged finance deals. Private equity sponsors in Australia have also been increasingly accessing the USD denominated Term Loan B market in the U.S., using foreign exchange hedging to mitigate the risks arising from the target's underlying cash flow being predominantly in AUD.

Lenders usually expect the equity to be structurally subordinated to the debt finance with the debt being lent to a special purpose finance company that is a wholly-owned subsidiary of the holding company.

### Security

Security is typically provided by way of a security interest over all of the assets of the transaction special purpose vehicles and, subject to compliance with the financial assistance provisions of the Corporations Act, the target companies. The target companies also cross-guarantee their obligations to the bank lenders.

The type of security granted over a company's assets in buyouts in Australia differs according to whether the security is granted over land or personal property (such as shares and other assets).

#### *Real property mortgages*

Security over land is granted by a real property mortgage. A real property mortgage must be registered with the land registries of the relevant states and territories. Registration requires that the real property mortgage sufficiently identifies the debt secured by the mortgage and the land and interest over which the mortgage is granted, and that it be duly executed and stamped (if applicable). The states and territories also have their own local formalities that must be followed for registration of real property mortgages, such as prescribed registration forms to be used and lodgment and execution requirements.

#### *PPSA*

A new regime for security over personal property was introduced under the *Personal Property Securities Act 2009* (Cth) (**PPSA**) and came into effect on 30 January 2012. The PPSA has fundamentally changed the way security over personal property is granted, perfected and registered in Australia. It applies to most forms of tangible and intangible personal property (including licenses, shares, goods, motor vehicles and documents of title), but does not cover land, fixtures, water rights and other excluded personal property such as certain rights and entitlements granted under statute.

The PPSA introduced a new concept of a 'security interest' which not only covers pre-existing forms of security interests in personal property such as fixed charges, floating charges, pledges and liens, but also extends to any interest in personal property provided for by a transaction that, in substance, secures payment or performance of an obligation.

Unless a security interest is 'perfected' for the purposes of the PPSA, it will lose priority to a perfected security interest in the same personal property and will vest in the grantor on insolvency. Unless the secured party has possession or control of the personal property, it may only perfect its security interest by an effective registration on the Personal Property Securities Register (**PPS**

**Register**) that operates as an electronic noticeboard. Registration on the PPS Register involves the secured party (or its agent) lodging a simple ‘financing statement’ online which is an electronic notice containing, among other things, certain information about the secured party, the grantor, the secured property and the security interest. Although there is no statutory obligation to register security interests on the PPS Register, a security interest granted by a company under the PPSA should be registered by a secured party within 20 business days of the date the relevant security agreement comes into force (unless the security interest is perfected by possession or control) to avoid the security interest vesting in the grantor on its insolvency.

### *Mortgage duty*

Security may be subject to mortgage duty depending on where assets subject to the security are taken to be located. Mortgage duty is being phased out in Australia and is now only applicable in New South Wales. (The proposed abolition of New South Wales mortgage duty that was previously scheduled for 1 July 2013 has been deferred indefinitely.) The rate of mortgage duty in New South Wales is currently 0.4% of the secured amount, subject to adjustment depending on the proportion of secured property located outside New South Wales. The duty is calculated on the total amount secured and in large transactions this can result in a substantial liability.

## **17. Are there financial assistance issues to consider when undertaking a buyout?**

### **Financial assistance permitted under regulated conditions**

In Australia, a company can provide financial assistance in certain prescribed circumstances.

Part 2J.3 of the Corporations Act regulates the provision of financial assistance by a company for acquiring shares in that company or a holding company. While Section 260A of the Corporations Act permits the giving of financial assistance, the section permits it under regulated conditions only.

Section 260A(1) states that:

‘A company may financially assist a person to acquire shares (or units of shares) in the company or a holding company of the company only if:

- (a) giving the assistance does not materially prejudice:
  - (i) the interests of the company or its shareholders; or
  - (ii) the company’s ability to pay its creditors; or
- (b) the assistance is approved by shareholders under Section 260B; or
- (c) the assistance is exempted under Section 260C.’

The intention of Section 260A(1)(a) is to allow the company to undertake normal commercial transactions which do not prejudice the company’s financial position. However, there is no definition of ‘material prejudice’ in the Corporations Act and this is, therefore, a question of judgment to be assessed on the particular facts and circumstances of each transaction. Particular regard must be paid to the assistance to be given and the financial consequences for the company and its shareholders.

As financial assistance is often complex in nature, it may be difficult to assess with certainty whether there will be any material prejudice.

Therefore, where the assistance does not fall within one of the exemptions under Section 260C (see the limited circumstances below where this applies), it is more usual to obtain shareholder approval under Section 260A(1)(b) than to rely on a determination that no material prejudice will occur.



## Shareholder approval

The requirements for obtaining shareholder approval (commonly known as the ‘Financial Assistance Whitewash Procedure’) are set out in Section 260B. Approval must be given by a special resolution passed at a general meeting of the company or by a resolution agreed to, at a general meeting, by all of the ordinary shareholders.<sup>2</sup>

However, it is not just the shareholders of the company giving the financial assistance who must approve that assistance:

- (a) under Section 260B(2), if the company will be a subsidiary of an Australian listed corporation immediately after the acquisition, then the financial assistance must also be approved by special resolution passed at a general meeting of that Australian listed corporation,<sup>3</sup> and
- (b) under Section 260B(3) if, immediately after the acquisition, the company will have an Australian holding company that is not listed and is not itself a subsidiary of an Australian corporation, the financial assistance must also be approved by a special resolution passed at a general meeting of that ultimate Australian holding company.

Sections 260B(5) to (7) set out procedures to be followed in obtaining the relevant shareholders’ approval. The first step is for the company to hold a directors’ meeting to approve the financial assistance documentation, which typically includes the relevant notice to shareholders, the shareholders’ resolutions setting out the details of the financial assistance being given and approvals being sought, and the relevant forms that are required to be lodged with ASIC.

Once the company’s directors have approved the financial assistance documentation, the relevant notice to shareholders, together with all documentation relating to the financial assistance that will accompany the notice to shareholders when sent to the shareholders, must be sent to the shareholders. At the same time, the company must lodge at ASIC a ‘Notification of Financial Assistance Details’ (ASIC Form 2602), together with the relevant exhibits.

Once the shareholders’ meeting has been held (or the appropriate resolutions have been passed by written procedure), a further notice must be lodged at ASIC notifying it of the intention to give financial assistance (ASIC Form 2601). Financial assistance cannot be given until at least 14 days after the lodgment of ASIC Form 2601. This means financial assistance typically can be only given after an acquisition is completed.

## Exemptions

The exemptions provided in Section 260C are for financial assistance that is given:

- (a) in the ordinary course of commercial dealing and consisting of:
  - (i) acquiring or creating a lien on partly paid shares in the company for amounts payable to the company on the shares; or
  - (ii) entering into an agreement with a person under which the person may make payments to the company on shares by installments;
- (b) by a financial institution in the ordinary course of its business on ordinary commercial terms;

---

<sup>2</sup> There is no need to hold a meeting where: (a) the company is a proprietary company and all of the members agree to proceed by way of a written resolution; or (b) the company is a single-member company and the resolution is passed by way of a written resolution signed by the sole member.

<sup>3</sup> An Australian listed corporation cannot approve the financial assistance by way of written resolution signed by all members but must hold a general meeting. This may not always be practical.

- (c) where a company issues debentures to raise money, by the subsidiary providing a guarantee or other security in the ordinary course of commercial dealing for the repayment of the money by the holding company;
- (d) under an employee share scheme approved by a general meeting of the company;
- (e) by a reduction of share capital or a share buy-back in accordance with Part 2J.1 of the Corporations Act;
- (f) under a court order; or
- (g) by a company discharging on ordinary commercial terms a liability incurred on ordinary commercial terms.

### Consequences of failure to comply

Failure to comply with Part 2J.3 of the Corporations Act does not affect the validity of the financial assistance or of any contract or transaction connected with it, nor is the company guilty of any offence (as it is considered to be a 'victim' (Section 260D(1) of the Corporations Act)).

However, any person who is involved in a company's contravention of Part 2J.3 contravenes Section 260D(2) of the Corporations Act. This is a civil penalty and the remedies available include:

- (a) disqualification from managing corporations (Section 206C);
- (b) a penalty of up to AUD 200,000 (Section 1317G); or
- (c) an order to compensate the company (including for any profits made by the person resulting from the contravention) (Section 1317H).

Section 260D(3) of the Corporations Act further provides that, where the involvement of a person is dishonest, then that person commits a criminal offence, which is punishable by a maximum penalty of a fine of 2,000 penalty units (AUD 340,000) or imprisonment of up to five years, or both (Section 1311 and Schedule 3).

Under Section 79 of the Corporations Act, that 'involvement' includes:

- (a) aiding, abetting, counselling or procuring the contravention;
- (b) inducing (whether by threats or promises or otherwise) the contravention;
- (c) being in any way (directly or indirectly) knowingly concerned in, or party to, the contravention; or
- (d) conspiring with others to effect the contravention.

Clearly this wide definition is capable of extending liability to lenders providing finances for the acquisition and/or the lawyers acting for the parties to the transaction.

## 18. What are the implications under the corporate benefit laws of Australia for a company providing financial assistance?

In Australia, directors of a company have a duty to act in good faith, for the benefit of the company as a whole and for a proper purpose. This duty arises both under the general law (as a fiduciary duty) and also under Sections 181 and 184 of the Corporations Act.

As this duty also applies to dealings between companies in a corporate group, when considering providing financial assistance for the acquisition of the company's shares, directors must continue to act in good faith for the benefit of that company. Although the benefit may be either direct or indirect,



it may still be difficult for a director to determine if the provision of the financial assistance (while in the best interests of the holding company and/or group of companies as a whole) is actually in the best interests of the company.

Therefore, Section 187 of the Corporations Act provides that, where a company is a wholly owned subsidiary, a director will be taken to act in good faith in the best interests of the subsidiary if:

- (a) the constitution of the subsidiary expressly authorizes the director to act in the best interests of the holding company; and
- (b) the director acts in good faith in the best interests of the holding company; and
- (c) the subsidiary is not insolvent at the time the director acts and does not become insolvent because of the director's act.

This section does not apply where the company is only partly owned. Therefore, if the financial assistance is to be given by a company for the acquisition of only some of its shares, then the directors would be required to act for the benefit of the company as a whole, including the minority shareholders.

When determining whether an act is for the benefit of the company, consideration must also be given to the solvency of the company. It has been held that if the company is insolvent or nearly insolvent, then the term interests of the company will include the interests of the creditors.

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

Typically, in any external administration (generally, liquidation, voluntary administration, or receivership) of a company, the secured creditors rank ahead of the unsecured creditors and the unsecured creditors rank ahead of the shareholders, although there are exceptions to this general rule.

For example, certain creditors (employees, those funding payments to employees, parties entitled to insurance claims, a voluntary administrator's entitlement to indemnity out of the assets of the company) may rank ahead of certain secured creditors.

In addition, during any voluntary administration period (similar to US Chapter 11 bankruptcy) there are restrictions on the enforcement by secured lenders of their security.

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

A number of Australian tax and stamp duty issues are relevant. Key relevant issues are set out below.

### Overall tax treatment of structure

The form of the entity that is used will be a key factor in determining the overall tax treatment of the structure. A key issue here is whether the relevant entity is regarded as a 'flow through' (transparent), entity for Australian tax purposes.

For example, a unit trust that is not regarded as a public trading trust can give rise to flow through treatment (i.e., no tax at the trust or trustee level) provided distributions are appropriately managed. Income can also retain its character when flowed through a trust.

Other structures such as limited partnerships may also be regarded as transparent entities for Australian tax purposes.

For non-resident investors, careful consideration needs to be given to the interaction of the Australian tax treatment of the structure and the tax treatment of the relevant entities in the investor's home jurisdiction.

Finally, the Australian income tax law includes a number of specific tax concessions aimed at promoting venture capital investments. For example there are capital gains tax (CGT) exemptions that apply to certain venture capital limited partnerships.

## Stamp duty

Stamp duty is a key consideration in relation to an acquisition, any restructuring to prepare an investment for trade sale or IPO and in relation to the trade sale or IPO itself. Stamp duty (including landholder duty) is a state-based tax and different rules apply depending on the relevant state or territory jurisdiction. Stamp duty is generally payable by the purchaser.

## Deductibility of interest and financing costs

Interest used to finance an acquisition is generally deductible for Australian tax purposes. For entities that are controlled by non-residents, the key limitation on interest deductibility is Australia's thin capitalization rules. For general (i.e., non-financial entities) these rules include a safe harbor debt limit that is very broadly equal to 75% of the average value of the Australian assets less certain non-debt liabilities. However the Federal Government announced in the 2013/14 Federal Budget that this gearing ratio would be reduced to 60% from the first year of income starting 30 June 2014, but this change is yet to be enacted. We note that the new Federal Government sworn in on 18 September 2013 announced that it intends to proceed with the amendments to the thin capitalization provisions proposed in the 2013/14 Budget, with a bill to give effect to this proposal introduced into Parliament on 17 July 2014. Higher gearing may also be possible by relying on an arm's length debt test. These rules are complex and need to be reviewed based on the individual characteristics of the relevant structure.

## Withholding tax

For non-resident investors, Australian withholding tax is an important issue to the extent returns will be repatriated by way of dividends, interest or royalties. The rates of withholding depend on whether the recipient of the dividend, interest or royalty is resident in a country with which Australia has negotiated a double tax agreement. For dividends, no withholding tax applies to the extent to which the dividends are franked (i.e., paid from taxed profits).

For the sale of shares in companies, the key issues are that stamp duty at 0.6% applies in some states to transfers of shares in unlisted companies while stamp duty at higher rates (approximately 5.5%) applies to the transfer of shares in an entity that is 'land rich' or a landholder. Similar rules apply for the acquisition of units in a unit trust.

Stamp duty may also apply to the transfer of units in a unit trust.

Stamp duty exemptions may be available for pre-exit restructuring that takes place within a group but the key issue is then whether the exemptions might be recaptured following an exit transaction.

## Income tax consequences of exit

The Australian income tax consequences of any exit need to be reviewed carefully. Key issues include the application of Australian income tax and CGT on any IPO or trade sale.

Another key issue is whether the investment is regarded for tax purposes as being held 'on revenue account' (e.g., an investment that is acquired with an intention of a relatively short term sale) or 'on capital account' (i.e., subject to the CGT rules).



For Australian resident investors, the application of Australian income tax or capital gains tax will be a significant issue.

In the case of non-resident investors for assets held on capital account, the Australian CGT rules limit the class of assets held by a non-resident that are subject to CGT. Following these changes, non-residents will generally only be subject to CGT in respect of real property, shares in companies the assets of which directly or indirectly principally consist of real property and the business assets of an Australian branch. This means that a non-resident is no longer subject to Australian CGT on the sale of shares in a company that does not hold substantial real property interests.

For assets held on revenue account, the application of any relevant double tax agreement is also an important consideration that may limit Australia's ability to tax a transaction.

## 21. What forms of exit are available?

In a solvent situation the most common forms of exit are an IPO or a trade sale - either a sale of shares or a sale of the underlying business. It is fairly common in Australia for private equity funds to run a 'dual track process' on any exit (meaning both forms of exit are prepared for) to test which form of exit offers the best pricing and terms.

It is also not uncommon for private equity funds to achieve a return on their investment during the life of the investment by undertaking a leveraged recapitalization. In that case, the return can take the form of a dividend and/or some other form of capital distribution or buy back.

## Austria

### 1. What structures do private equity funds typically use to manage their funds?

Private equity funds are most often structured as either a stock corporation within the meaning of the Austrian Stock Corporation Act (*Aktiengesetz*) (**AktG**), or a limited liability company within the meaning of the Austrian Limited Liability Company Act (*Gesetz über Gesellschaften mit beschränkter Haftung*) (**GmbHG**), potentially qualifying as a “MiFiG” (*Mittelstandsfinanzierungsgesellschaft*, a certain type of stock corporation or limited liability company). Beneficial tax treatment is available for MiFiGs and for distributions made by MiFiGs, if certain conditions are complied with.

Currently, partnership structures are rarely used for setting up private equity funds in Austria.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in Austria?

Private equity funds that intend to carry on their business activities in Austria by purchasing stakes in companies domiciled in Austria do not need to obtain a license. A license is only required if the manager of a private equity fund intends to distribute fund units to Austrian clients. These license requirements are provided for in the Austrian Investment Funds Act and the Austrian Alternative Investment Funds Manager Act (**AIFMG**). The *Finanzmarktaufsicht* (**FMA**) is the competent authority for issuing this license.

#### Requirements under the Austrian Investment Funds Act

Requirements for licenses under the Austrian Investment Funds Act include fulfillment of certain requirements in relation to:

- (a) the corporate structure (e.g., the legal form of the company, shares, duration of the company);
- (b) the share capital (e.g., in relation to the level of initial capital, the requirement for gilt-edged investments);
- (c) managers and members of the supervisory board (compliance with incompatibility provisions and adequate qualification of these persons);
- (d) implementation of adequate risk management principles;
- (e) compliance with legal requirements under the Austrian Banking Act (*Bankwesengesetz*); and
- (f) depending on the business activities carried out, compliance with further requirements under the Austrian Securities Supervision Act (*Wertpapieraufsichtsgesetz*).

#### Requirements under the AIFMG

License requirements under the AIFMG include:

- (a) evidence showing that the alternative investment fund manager will be able to meet the conditions set out in the AIFMG;
- (b) a sufficient level of capital resources (initial capital and own funds) of the alternative investment fund manager;
- (c) adequate qualification of persons who effectively conduct the business of the alternative investment fund manager;



- (d) suitability of shareholders or members of the alternative investment fund manager that have qualifying holdings; and
- (e) the head office and the registered office of the alternative investment fund manager to be located in Austria.

### 3. Are there any approvals required for investments by foreigners in Austria and, if so, what is the process?

#### Foreign investment restrictions

No specific approvals are required for investments by foreign private equity funds in Austria. Accordingly, in principle, there are no restrictions on the acquisition of shares in a limited liability company (**GmbH**) or stock corporation (**AG**). However, exceptions apply for certain specific types of business. Approvals will, for example, be required for the acquisition of a controlling shareholding in an Austrian credit institution.

In addition, acquisitions of 25% or more of a controlling interest by a non-EU, non-EEA and non-Swiss person of an Austrian enterprise engaged in a particular – protected – industry sector defined under the Foreign Trade Act (*Außenwirtschaftsgesetz*) (**AußWG**) must seek the advance approval of the Austrian Ministry of Economic Affairs. Protected sectors include the defense equipment industry, security services, energy supply, water supply, telecommunication, traffic and infrastructure in the healthcare and educational sector.

The application for approval by the Ministry must be submitted before entering into a legally binding agreement to acquire the relevant interest or before announcing the launch of a public offer in an enterprise of the protected sector. Additionally, the **AußWG** provides for an *ex officio* review procedure. The waiting time for the approval is between one month from receipt of the application by the Ministry to a maximum of two months from the receipt of the Ministry's decision (to be issued within one month following the application for clearance) to initiate an in depth investigation of the transaction by the applicant. Any prohibition will have to be reasoned and is subject to appeal. The sanctions for violation of the approval requirement include the invalidity of the acquisition agreement. Additionally, even negligent violations of the approval requirements are subject to fines amounting to up to 360 days income or up to one year imprisonment.

#### Exchange controls

All capital transfers between residents and non-residents, as defined by the Foreign Exchange Act (*Devisengesetz*) (**DevG**), are subject to Austrian National Bank controls. Under the **DevG**, the Austrian National Bank is generally vested with the power to issue restrictions on foreign exchange as well as on domestic currency and certain transactions must be reported to the National Bank. However, the National Bank has not made wide use of its power. At this time, payments for all business transactions (with very few exceptions) are generally permitted by general regulation of the National Bank.

### 4. Who are the relevant regulators in Austria and how much interaction would one generally expect when undertaking a buyout?

In Austria there is no general corporate regulator, but rather various regulatory authorities with different responsibilities. The primary regulatory authorities in Austria in a corporate context are:

- (a) the Financial Market Authority (**FMA**) (*Finanzmarktaufsicht*) – the regulator of financial services laws;
- (b) the Vienna Stock Exchange (*Wiener Börse*) – the only stock exchange in Austria where securities are traded;

- (c) the Austrian Takeover Commission (*Übernahmekommission*) (**ATC**) – an independent body responsible for supervising public takeover bids;
- (d) the Cartel Law Court (*Kartellgericht*) – the court responsible for competition/antitrust regulation;
- (e) the Cartel Law Authority (*Bundeswettbewerbsbehörde*) – plays an important role in the context of merger control; and
- (f) the Ministry of Finance (*Bundesministerium für Finanzen*) – the taxation authority.

The level of involvement of the FMA and ATC mostly depends on whether the target is a publicly listed company. The ATC is only responsible for supervising public takeover bids and therefore is not involved in takeovers of private companies.

The level of interaction with the other authorities largely depends on the nature of the transaction (such as whether there are competition/antitrust issues and whether it is a takeover of a bank or insurance company).

## 5. How are buyouts typically undertaken in the private and the public markets?

### Private companies

Buyouts of private companies mostly take place by way of a negotiated acquisition. Share sale and transfer agreements are prepared, negotiated and executed. In the case of an acquisition of a private limited liability company, a share sale and transfer agreement in the form of an Austrian notarial deed is required. Subsequently, the new shareholder has to be registered with the companies register. The share sale and transfer agreement records the terms of the sale and transfer, the rights and duties of the parties involved and the representations, warranties and liabilities.

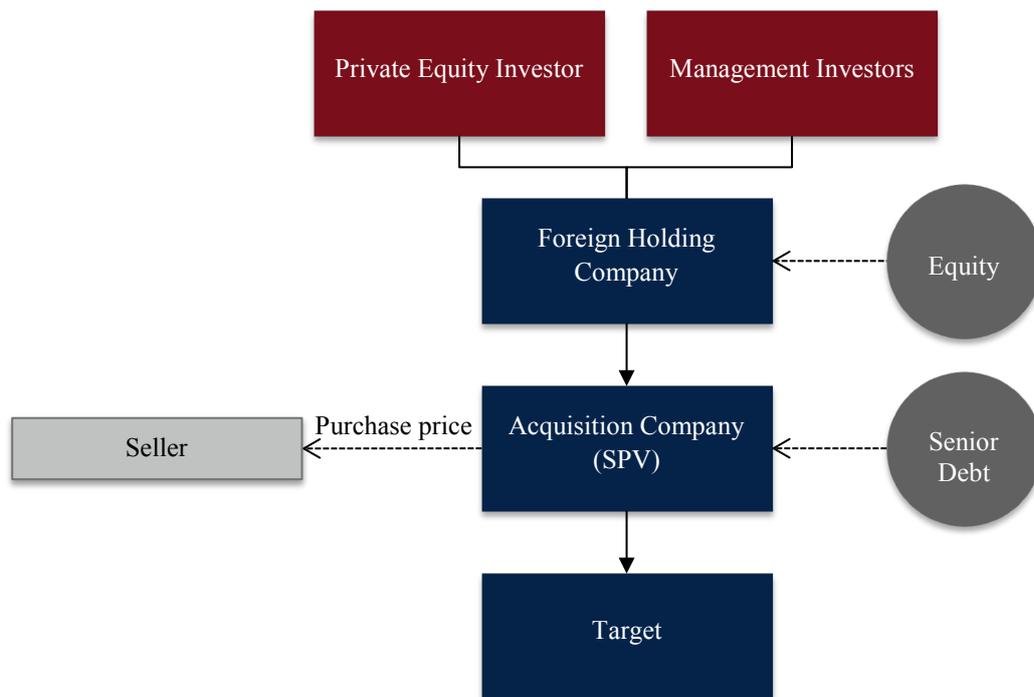
### Publicly listed companies

Takeovers of publicly listed companies require the preparation of a public takeover bid. As many Austrian companies listed on the Vienna Stock Exchange have a controlling shareholder, the bidder often negotiates a private share sale and transfer agreement with the current shareholder first, and only subsequently launches a public takeover bid addressed to the remaining shareholders of the company. The Austrian Takeover Act regulates these types of public takeover bids. The Act on Squeeze-outs provides for a mechanism that enables a shareholder with a stake of at least 90% of the share capital to achieve control of 100% of the share capital. Further, the AktG also enables the parties to structure a takeover by means of a merger.



## 6. What is the typical corporate structure used when doing a buyout?

Acquisition structures vary from transaction to transaction, although it is fairly common to see a two-level holding company structure adopted along the following lines:



This structure allows for the senior debt finance to be provided to the Acquisition Company SPV, while the equity contribution from the private equity fund or funds is contributed at the holding company level and subsequently contributed down to the Acquisition Company SPV in the form of unsecured loan funds or equity. It is not uncommon to use Luxembourg-based holding companies for these purposes.

More elaborate structures exist on larger and more complex deals, particularly where any debt funding involves mezzanine funding sources that may need to be structurally subordinated to the senior financiers but rank ahead of any equity contributed by the private equity fund or funds.

It is common to use a GmbH as the acquisition company. The GmbH is the most frequently used business organization in Austria, and it is governed by the GmbHG. In principle, the shareholders of a GmbH cannot be held liable by creditors of the GmbH. Exceptions apply under certain circumstances, for example where:

- (a) there is no clear distinction between the assets and liabilities of the company as opposed to those of its shareholder(s);
- (b) where the registered share capital of the GmbH is far too low for the requirements of the type of business the company engages in; or
- (c) where the legal form of GmbH is misused to the detriment of the company's creditors.

The minimum share capital of a GmbH is generally speaking EUR 35,000 although only half is payable in the course of establishing the company.

A GmbH may be established and owned by a single shareholder, including multiple layer structures of sole shareholding. There are no requirements for the shareholders to be Austrian nationals.

Mechanisms exist in Austria to 'immobilize' the movement of shares, so that shares in a GmbH are

not evidenced by share certificates and a notarial deed is required to effect their transfer. Shares in a GmbH may not be publicly traded. Shareholders must be registered with the companies register, but registration is declaratory in nature, so not a required prerequisite to a share transfer. The GmbH's general assembly is deemed to be the supreme body of the company, in particular enjoying an extensive instruction right *vis-à-vis* the company's management.

## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

#### *Private companies*

A buyout in a private context primarily requires the drafting of a share sale and transfer agreement. As indicated in the answer to question 6, this must be in the form of an Austrian notarial deed. At the request of the parties, the notarial deed may also be executed in a foreign language, (e.g., English), provided the notary public recording the notarial deed is a generally sworn and court-certified expert for this language.

Further, depending on the nature of the business, shared service agreements may be necessary to structure future co-operation (e.g., the future use of administrative services, trademarks, and licenses in case of a spin-off). Depending on the acquisition structure, additional corporate documentation (e.g., call or put option agreements or shareholder agreements at the Holdco level) may be necessary or expedient.

#### *Publicly listed companies*

The transaction documentation required in relation to publicly traded companies mainly depends on the structure of the transaction. In the case of a company with a widely dispersed shareholder base, the main document would be an offer document prepared in accordance with the Austrian Takeover Act. In addition to the terms of the offer and a description of the shares to be acquired, the bidder must disclose its plans in relation to the future business policy of the target (e.g., possible integration plans into the purchaser group).

The offer documents must be reviewed by an independent auditor, who must, among other things, confirm that the offer price meets the legal requirements. There are two minimum thresholds as follows:

- (a) the highest price paid by the bidder, or persons acting in concert, during the last 12 months; and
- (b) the average share price of the shares of the target company during the preceding six months.

Further, management of the target company must publish a statement in relation to the offer document regarding the fairness of the offer price. This statement must also be reviewed by another independent auditor. Further, the supervisory board is obliged to publish a statement regarding the offer. Finally, the works council is allowed to publish a statement.

As many of the Austrian publicly listed companies are controlled by a majority shareholder or a group of shareholders acting in concert, the bidder has to negotiate and agree with this majority shareholder or the group of shareholders to acquire control. Therefore, in this case a separate share sale and transfer agreement would be negotiated with the majority shareholder(s) before a public takeover bid is launched.



## Banking

The main banking document is the senior facilities agreement under which the senior debt facilities (typically amortizing and non-amortizing term loans with working capital lines and in some instances capital expenditure or acquisition facilities) are documented.

If there is subordinated or mezzanine debt (the terms are interchangeable in the Austrian market), there is typically a separate facility agreement under which this debt is made available and an inter-creditor or subordination deed recording the respective rights of the senior and subordinated/mezzanine lenders.

Security is usually held by a security trustee for the lenders under a separate security trust agreement. This is usually the first document executed for stamp duty reasons.

Fees are usually recorded in a separate letter rather than in the main facilities agreement.

## 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

### Private companies

In the context of an acquisition of a private company, the buyer is mainly protected by the terms and conditions of the share sale and transfer agreement. In this agreement, the seller usually gives representations and warranties about certain features of the shares and of the business, whereas the company itself does not give separate representations and warranties. In the Austrian market it is uncommon for managers to directly give any representations or warranties for the benefit of the buyer. If at all, managing directors may give these representations and warranties in favor of the seller.

It is very common for the parties to agree that:

- (a) the liability of the seller is capped at a certain threshold amount;
- (b) minor damages will not be recoverable (*de minimis* rule);
- (c) there are time limits for the assertion of warranty claims;
- (d) the seller has certain rights to participate in the defense of third party claims; and
- (e) the liability of the seller is limited to a certain extent in so far as the damage need not be compensated if it results from circumstances which were disclosed in the course of the due diligence.

It is also common practice for a portion of the purchase price to be held in an escrow account by the purchaser. Warranty and indemnity insurance is not commonly seen in the Austrian market, although the number of transactions in relation to which this insurance is used seems to be increasing. Finally, auction processes are common in Austria for stakes in larger businesses.

### Publicly listed companies

Buyer protection differs substantially in the public context. In the context of a takeover bid for publicly listed companies the parties are not in a position to negotiate representations and warranties individually. The bidder must follow the rules laid down in the Austrian Takeover Act that basically only requires the sellers to warrant that they are in a position to transfer (unencumbered) ownership in their shares.

The most important tool for the protection of a bidder in a public context is to make the takeover bid subject to conditions precedent. Besides antitrust law issues, which regularly have to be covered by

conditions precedent, the bidder may also make the offer subject to certain material adverse change clauses. However, in the context of a mandatory offer, the bidder may only provide for conditions that are legally required to be part of the offer documents (e.g., merger control clearance).

## 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

There is no specific set of rules covering conflicts of interest in relation to a management buyout in Austria. Management may, however, be in a position of conflict due to the contractual obligations it owes to the target company under statutory law.

The AktG and the GmbHG provide for rules, according to which the managing directors (i.e., the company's (day-to-day) management) and the members of the supervisory board must not misuse their positions to advantage themselves or improperly use information of the corporation to their advantage. In general, the members of the management board must disclose any potential conflict of interest to the supervisory board or, if there is no supervisory board, the shareholders. The members of the supervisory board in general must take the interests of the company into account, and typically must represent the company in that transaction. Similarly, members of the supervisory board, who are interested in a particular business transaction of the company, must disclose this fact to the chairman of the supervisory board. Moreover, the entire supervisory board must approve certain transactions between a company and a member of its supervisory board. Finally, according to general fiduciary obligations, a member of the supervisory board who participates in a buyout must basically abstain from any board decision and decision-making in relation to the buyout.

In a public context, the Austrian Takeover Act requires that there be a statement of the supervisory board in relation to the proposed takeover in addition to the statement of the management board. Members of the management board who are personally involved in a management buyout must disclose any involvement from the outset and must abstain from recommendations to accept the offer. Therefore, in that situation, the statement of the supervisory board is of particular relevance for the information of the shareholders.

## 10. How are the equity arrangements typically regulated in a buyout?

The shareholders of a GmbH have considerable freedom to determine the shareholders rights in the articles of association. For example, it is permissible to provide for different dividend rights in the articles of association. It is also possible to provide for (additional) equity arrangements in a separate shareholders agreement.

The articles of association must be filed with the companies register and it is therefore publicly available for inspection. Shareholders agreements do not need to be filed with the companies register.

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

The shareholders of a GmbH (typically used as a holding or acquisition company) have considerable freedom under the GmbHG in relation to the types of equity security that may be issued and the level of rights tailoring that can occur. Within the articles of association, individual shareholders can be granted preferential dividend rights, but also preferential control rights (such as the right to nominate members of the management board, the right to approve decisions of the management board and the right to approve resolutions of the shareholders' meeting).



## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

### Private limited liability companies

The articles of association typically govern issues such as board constituency, differential director voting rights and the removal of directors. These issues are also often dealt with in separate shareholders agreements.

#### *Board constituency*

A GmbH must have a management board. Certain other factors, such as the size of the work force, the size of the share capital, the number of shareholders and the object of the company, determine whether a GmbH must also establish a supervisory board. (A typical holding or acquisition company often does not have a supervisory board.)

A GmbH is only required to have one director on the management board, which must not be a legal entity. There is however no prescribed maximum number of directors. There are few restrictions on who can become a managing director. In particular, a director is not required to be resident in Austria and there is no nationality requirement. The company should, however, effectively be seen to be managed from within Austria (for tax reasons). Therefore, it is advisable that at least one of the directors be resident in Austria.

#### *Board appointment and removal*

In general, private equity funds (in their capacity as shareholders of a GmbH) may be entitled to appoint, and to remove, a specified number of directors. More specifically, the shareholders in a shareholders' meeting or in writing appoint directors of a GmbH. Further, shareholders may be appointed to the management board by a respective resolution of the single shareholder if this is permitted in the articles of association. The articles of association may also grant special rights to manage the company to individual shareholders. The appointment of these managing directors may not be revoked except for good cause, and even if good cause exists, a court decision is required.

#### *Other rights*

It is common to provide for shareholders entitled to appoint or remove a specified number of directors to also have specific rights to be directly informed by the managing directors in relation to important business developments and financial matters.

#### *Employee representation*

Employees are entitled to representation on the supervisory board, but not on the management board. In principle, employee representatives on the supervisory board have the same rights and obligations as the other representatives on the supervisory board.

### Stock corporations

Generally, shareholders of a stock corporation secure their influence on the board composition and decision making of the management board primarily by separate shareholders agreements.

#### *Board constituency*

AGs may have one or more individuals on the management board. As is the case with GmbHs, legal entities may not be appointed to the management board. There is also no maximum number of directors for an AG. There is much less freedom to provide for differential shareholder rights within the articles of association than in relation to a GmbH. Nevertheless, it is permissible to provide for the right of a shareholder to nominate up to one third of the members of the supervisory board of a publicly listed AG and up to one half of the members of the supervisory board of an unlisted AG. The

influence on the composition of the members of the supervisory board is an important precondition for exercising influence on the composition of the management board as the supervisory board appoints members of the management board.

#### *Appointment and removal of directors*

As is the case with the GmbH, the appointment of a member of the supervisory board of an AG may be revoked for good cause by a court decision. An individual shareholder may apply to have a member of the supervisory board removed.

### **13. What measures are commonly used to give a private equity fund some level of control over key operating and financial decisions made by a portfolio company?**

Mechanisms to give a private equity fund some level of control over key operating and financial decisions are typically provided for in shareholders agreements.

#### **GmbH**

However, in the case of a GmbH these rights may also be provided for in rules of procedure or in the articles of association. As discussed in the answer to question 11, important decisions of the company can be made subject to approval by an individual shareholder or shareholders. This also applies to the right to appoint one or more directors to the board of the portfolio company and the right to remove individual members of the management board. Further, the right to receive financial and operating information on a regular basis may be set out in the rules of procedure or the articles of association.

#### **AG**

If the target company is an AG, it is more difficult to secure control over key operating and financial decisions of the target company. Shareholders of an AG may only be granted a right to nominate up to one third of the members of the supervisory board in listed companies (and up to half in privately held entities), whereas nomination rights in relation to members of the management board are not permissible.

In practice, however, major shareholders of an AG are typically in a position to influence major board decisions via their representatives on the supervisory board or by direct communication with the management, as the members of the management board would be interested in maintaining their position on the board. A major shareholder may decide to bring a motion of no confidence at a shareholders' meeting. Consequently, the supervisory board would normally be obliged to remove the relevant member of the management board from office with immediate effect. Therefore, the threat of a motion of no confidence also causes members of the management board to follow the informal instructions of major shareholders.

### **14. What employment terms are generally imposed on management in a buyout?**

Generally, a buyout does not affect an employee's position under applicable Austrian employment law. A managing director of a GmbH generally qualifies as an employee under Austrian labor law. However, certain protective laws (particularly the Work Hours Act) do not apply to managing directors. As members of the board of directors of an AG do not qualify as employees under Austrian labor law, a buyout also has no effect on their position under labor law.

Nevertheless, generally some sort of management and executive employee participation schemes are implemented in connection with buyouts. The form of these schemes very much differs, including participation via (phantom) shares and options as well as actual participations (via employee participation vehicles).



## 15. What equity incentives can be offered to management and how are they typically structured?

There are several forms of equity incentive that might be offered to management. As mentioned in the answer to question 14, the form of these schemes varies, ranging from participation via (phantom) shares and options to direct participations (via employee participation vehicles).

## 16. How are buyouts typically debt financed and secured?

While it varies from transaction to transaction, typically 35-55% of the cost of an acquisition is provided from debt sources provided by banks and financial institutions. Austria has a large number of domestic and international banks and financial institutions willing to participate in leveraged finance deals.

Lenders usually expect the equity to be structurally subordinated to the debt finance with the debt being lent to a special purpose or acquisition finance company which is a wholly owned subsidiary of the holding company.

Security is typically provided by way of a fixed and floating charge over the entire assets of the transaction, special purpose vehicles and, only to a limited extent due to Austrian capital maintenance rules, the target companies.

## 17. Are there financial assistance issues to consider when undertaking a buyout?

### Financial assistance

Under Austrian law, it is generally not permissible for an AG to provide financial assistance to third parties for the acquisition of its own shares (Section 66a of the AktG). The AG's management may be held personally liable for agreements entered into in violation of this provision. As no corresponding provision exists for GmbHs, financial assistance is generally allowed for a GmbH. However, financial assistance is always subject to capital maintenance provisions that already set out substantive stringent limitations (see next paragraph below). Financing arrangements that contravene Austrian mandatory capital maintenance provisions are at risk of being null and void.

### Capital maintenance

Under Austrian law, shareholders in a GmbH or an AG are generally not permitted to reclaim their equity and other financial contributions (Section 82 of the GmbHG and Section 52 of the AktG). The provisions in relation to limited liability companies are also applicable to limited partnerships involving GmbHs or AGs as unlimited partners (i.e., GmbH & Co KG and GmbH & Co AG). Therefore, in general, the repayment of capital to shareholders of a GmbH, GmbH & Co KG, GmbH & Co AG and AG is not permitted under Austrian law.

Shareholders are only entitled to:

- (a) dividends (i.e., the distribution of the net balance sheet profits of the GmbH or AG);
- (b) funds and assets received in the course of a formal capital reduction;
- (c) any liquidation surplus, subject to creditor protection provisions; and
- (d) consideration received in arm's length transactions with the company.

Additional payments and benefits received by the shareholders are qualified as being in breach of the Austrian capital maintenance rules and result in the invalidity of the relevant transaction.

It is permissible for shareholders to pledge their shares in the target company and to pledge or assign their claims for dividends. This is particularly relevant in the context of acquisition financing. In this context it should also be mentioned that upstream and cross-stream guarantees and securities are generally permitted in Austria if they do not breach the Austrian capital maintenance rules. As a consequence, upstream and cross-stream guarantees and securities are subject to certain stringent restrictions and are only permissible if, and to the extent that, the granting of the security:

- (a) is commercially justified;
- (b) is at arm's length; and
- (c) does not, if enforced, endanger the solvency of the security provider.

For this purpose, finance documents, such as loan agreements and the related security documents, usually include provisions setting out certain restrictions on the scope and the enforcement of the security (limitation language), which effectively limits the secured parties' security interest and enforcement rights. The limitation language, albeit restricting the value of the collateral, is market standard in Austria.

## 18. What are the implications under the corporate benefits laws of Austria for a company providing financial assistance?

Unlike in many other countries, there are no corporate benefits laws in Austria. However, Austrian courts interpret financial assistance provided beyond the limits of capital maintenance rules (as explained in the answer to question 17) as a breach of mandatory law. Therefore, a transaction of this type will be rendered, at least partially, null and void by operation of law. The company's managing directors and/or board members are also at risk of being held liable for having acted negligently. This could in particular be the case if they:

- (a) permitted payments to shareholders which were subsequently deemed to be in breach of capital maintenance rules;
- (b) allowed the granting of security later deemed to be in breach of capital maintenance rules; or
- (c) were involved in the drawing up, or the provision, of incorrect financial statements.

Finally, the Austrian Code of Corporate Governance sets out recommendations to be observed by the management and the supervisory board of Austrian AGs.

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

Typically, the secured creditors rank ahead of the unsecured creditors and the unsecured creditors rank ahead of the shareholders.

Certain claims arising usually after the commencement of insolvency proceedings (such as costs of the proceedings, costs for administration and realization of the debtor's assets, taxes, fees, social security payments and other public charges, wages of employees for periods after the commencement of the insolvency proceedings or claims arising out of bilateral contracts) are generally fully and immediately paid when due and not subject to any *pro rata* payment limitations.

Austrian law provides for no debt/equity swap in connection with an insolvency. Austrian insolvency laws essentially distinguish between two types of insolvency proceedings: bankruptcy proceedings (*Insolvenzverfahren*) and restructuring proceedings (*Sanierungsverfahren*).

While bankruptcy proceedings usually lead to a winding-up of the debtor's estate and the distribution of the proceeds among its creditors, the aim of restructuring proceedings is to enable the debtor to



continue its business and to be discharged from its debts. To this end, in relation to restructuring proceeds, the debtor must present a restructuring plan to its creditors, offering payment on a *pro rata* basis of at least 30% of the outstanding claims within two years. At the end of this period and payment of the amount offered, creditors will have no further claims against the debtor and the shareholders will hold shares in a debt-free company. Therefore, a shareholder may end up as beneficiary of a successful restructuring (under an insolvency proceeding), despite generally being a residual creditor. A residual creditor is an unsecured, subordinate creditor whose claims against the debtor may only be satisfied after the claims of other creditors.

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

A number of Austrian tax issues are relevant. Key issues that commonly arise are set out below.

### Overall tax treatment of structure

The form of the entity that is used, both in relation to the fund and to perform the buyout, is a key issue in determining the overall tax treatment of the structure. An important issue is whether the relevant entity is regarded as a ‘flow through’ (transparent) entity for Austrian tax purposes.

For example, a fund established in the form of a partnership may give rise to flow through treatment (i.e., no tax at the fund level). As partnerships are rarely used, however, this answer focuses on the commonly-used legal form, the corporation, as well as corporate investors.

For non-resident investors, careful consideration needs to be given to the interaction of the Austrian tax treatment of the structure and the tax treatment of the relevant entities in the investor’s home jurisdiction.

### Transfer taxes

Austria imposes a capital transfer tax of 1% (*Gesellschaftsteuer*) on equity contributions of a direct shareholder in its Austrian subsidiary. In most cases, this levy may be avoided by contributing the funds via a grandparent company. The capital transfer tax will be abolished as of January 1, 2016.

### Deductibility of interest and financing costs

Interest used to finance an acquisition is generally deductible for corporate investors for Austrian tax purposes (i.e., there are no thin capitalization rules). However, interest expenses relating to the acquisition of (foreign) shareholdings from related parties are not tax deductible. Furthermore, the term ‘interest’ is interpreted in a rather narrow sense if the acquisition concerns a share deal. Therefore, when structuring the financing of the acquisition, careful consideration should be given to the means of financing used to safeguard the deductibility. If the buyout is structured as an asset deal, these restrictions do not apply. Private investors may not deduct the interest immediately when acquiring shares or stock but a deduction may be possible on exit.

### Withholding tax

For non-resident investors, Austrian withholding tax is an important issue to the extent returns are to be repatriated by way of dividends, interest or royalties. The rates of withholding tax depend on whether the recipient of the dividend, interest or royalty is resident in a country with which Austria has negotiated a double tax agreement. For corporate investors no withholding tax applies on dividends, interest and royalties if they are resident in the EU and comply with further conditions as laid down under Austrian law.

### Income tax consequences of exit

The Austrian income tax consequences of any exit need to be reviewed carefully.

### *Resident investors*

For Austrian resident investors, the application of the Austrian Income Tax Act (*Einkommensteuergesetz 1988*) (**Income Tax Act**) or the Austrian Corporate Income Tax Act (*Körperschaftsteuergesetz 1988*) (**Corporate Income Tax Act**) is a significant issue. For private investors (investors that hold the assets privately), generally, any capital gain on a sale is subject to withholding tax at a rate of 25% (most likely to be increased to 27.5% as of January 1, 2016). Other principles apply if the participation in the corporation was at least 1% and was held for a period of five years preceding March 31, 2012. For corporate investors the exit triggers corporate income tax at the rate of 25%.

### *Non-resident investors*

Capital gains realized on the sale of shares in an Austrian company are taxable at a rate of 25% (most likely to be increased to 27.5% as of January 1, 2016), unless a double tax treaty allocates the taxing right to the country where the seller is resident. Based on Austrian domestic law and treaty law, non-residents are most likely to be taxed in Austria only in respect of real property, shares in companies the assets of which directly or indirectly principally consist of real property and the business assets of an Austrian branch. If no double tax treaty is in place between the country the investor is resident in and Austria, the sale of shares in an Austrian company is also subject to corporate income tax (which also covers capital gains).

### **The preferential tax treatment of the new MiFiG**

The Corporate Income Tax Act contains detailed provisions concerning the investment of a MiFiG. If certain conditions are fulfilled, income resulting from the investment in participations as defined in Section 6b of the Corporate Income Tax Act is exempt from corporate income tax at the level of the MiFiG. Broadly speaking, participations that come within Section 6b apply to companies that have a minimum share capital of EUR 7.3 million, whose scope of business is limited to the investment of equity and related business, who comply with certain investment requirements and in which public corporations hold not more than 50% of the shares. This beneficial tax treatment is unwound with retroactive effect if the MiFiG ceases to pursue the investments within a period of seven years after it has been registered with the commercial register.

Generally speaking, certain legal actions, such as the issue of new shares in a GmbH or AG or, in certain cases, transfer of funds (e.g., by means of capital grant or waiver of claims) to these companies, trigger a capital transfer tax liability. However, the issue of shares by the MiFiG is exempt from capital transfer tax.

## **21. What forms of exit are available?**

The most common form of exit in a solvent situation in Austria is a trade sale. IPOs are less common. In relation to a trade sale, a sale of the shares in the target company is more common than the sale of the underlying business. However, the Austrian Commercial Code provides for a transfer of the existing contractual relationships of a target company by means of an asset deal. In some cases, ‘dual track processes’ are run to maximize profits.



## Brazil

### 1. What structures do private equity funds typically use to manage their funds?

#### Brazilian funds

Private equity funds commonly use one of the following four structures to manage funds raised from their Brazilian investor base:

- (a) an equity investment fund (*Fundo de Investimento em Participações*) (**FIP**);
- (b) an emerging companies investment fund (*Fundo Mútuo de Investimento em Empresas Emergentes*) (**FMIEE**);
- (c) a real estate investment fund (*Fundo de Investimento Imobiliário*) (**FII**); and
- (d) a Brazilian holding company structure for foreign direct investments.

Other types of funds and investment structures also exist (e.g., infrastructure equity investment funds which must invest at least 90% of their net equity in shares or subscription bonuses of corporations directly engaged in new infrastructure projects in Brazil).

Each of these structures is discussed in more detail below.

#### *FIP*

The FIP is used to raise funds in the Brazilian capital market to acquire and manage shares, debentures, subscription bonuses and/or other securities convertible or exchangeable into shares of Brazilian publicly or closely held corporations (with certain corporate governance rules needing to be observed by publicly or closely held corporations). FIPs may invest in corporations that operate in any kind of business. They are generally used for investments in corporations operating in specific sectors, as determined in the fund's charter. Note that a FIP may only invest in certain securities, nor is it permitted to invest abroad, directly in real estate, in securities issued by the funds' administrator or, as a general rule, in companies that have the participation of certain related parties. There are, however, no limitations on the FIP investing in companies whose corporate purpose is the investment in real estate properties or in companies who own real property.

Note also that FIPs may not invest in limited liability companies (the most common corporate form in Brazil). This means that a FIP needs to be converted to an SA (either public or privately owned) prior to completion of the transaction. Foreign private equity funds can set up a FIP as a vehicle to make investments, subject to the registration requirements of the Brazilian Central Bank (refer to the answer to question 3).

Further, the FIP must participate in the decision-making process of the invested corporation, either by:

- (a) holding shares which are part of the controlling block of the company;
- (b) executing a shareholders agreement; or
- (c) executing any agreement which ensures that the FIP has effective influence in relation to the administration of the invested company.

#### *FMIEE*

The FMIEE structure is aimed at fundraising for emerging companies (i.e., companies with annual net revenues, or consolidated annual net revenues, of less than BRL 150 million, although that threshold only applies to the first investment performed by the FIEE portfolio). The FMIEE's funds cannot be

used to invest in a company whose share control is held by a group of companies (conglomerate) with consolidated net equity exceeding BRL 300 million.

At least 75% of the FMIEE's investments must be made in shares, convertible debentures and subscription bonuses of emerging companies. The remainder may be invested in fixed income funds and/ or in fixed income securities, or in securities of publicly-held corporations acquired on the stock exchange or in an organized over-the-counter market.

Similar to the FIP, the FMIEE may not invest in offshore markets, directly in real estate and/or in the acquisition of shares issued by the fund's administrator, nor can it invest in derivatives (except for investments made as part of a *bona fide* hedging transaction).

### *FII*

The FII is used to raise funds in the Brazilian capital market to invest in certain types of securities where the underlying investment or assets are related to the development of real estate projects (e.g., construction, acquisition of built real estate, or investment in projects aimed at allowing access to housing and urban services, including in rural areas).

The FII may invest a portion of the total value of the quotas paid in by the investors of the FII in quotas of financial investment funds, fixed income funds and/or fixed rate bonds to satisfy the FII's liquidity needs.

The FII cannot exploit commercially (i.e., directly) its real property, except if by means of renting or leasing, nor may it invest any amounts raised in Brazil abroad. The investors must not have any *in rem* rights in relation to these real properties.

The FII must distribute at least 95% of its net profits (considered at the fund level) to its quota holders, calculated in accordance with the cash method, at least semi-annually. Note also that the amount is not subject to depreciation or amortization.

### Company/holding company

The final structure commonly used is the company or holding company structure. In Brazil, the most common corporate forms are limited liability companies (**Ltda.**) and corporations (**SA**).

A minimum of two equity holders is required for the organization of either type of company. There is no minimum capital investment required to carry on business in Brazil, except for certain regulated activities (e.g., banking, insurance and trading companies). Further, the capital of Brazilian companies must be paid in the local currency (Brazilian Real (BRL)) or in cash convertible assets.

### Foreign funds

It is also common to have offshore structures, such as funds incorporated in the British Virgin Islands and Luxembourg or companies incorporated in other jurisdictions which offer some type of benefit relevant to the transaction (e.g., a tax benefit or greater confidentiality). These structures, however, must be analyzed on a case-by-case basis and involve outside jurisdiction analysis.

## 2. Do funds need to be licensed by any regulatory authority to conduct business in the jurisdiction?

The FIP, the FMIEE and the FII must be managed by an asset manager that is registered with the Brazilian Securities and Exchange Commission (**CVM**). FIPs, FMIEEs and FIIs must comply with the CVM regulations.



A company is not subject to registration as an asset manager with the CVM, except if it is listed on the stock exchange. Note, however, that companies are incorporated by being registered with the relevant local commercial registry.

### 3. Are there any approvals required for investments by foreigners in the jurisdiction and, if so, what is the process?

#### General

In general, Brazilian law does not prohibit or restrict the participation of foreign investment in business activities. With certain exceptions, foreign investors are free to establish any business in Brazil. Those few areas in which foreign investment is either totally prohibited or limited to minority interests include some telecoms and media segments. In these restricted areas, foreign investors may need to use different kinds of structures including joint ventures and consortia depending on their requirements.

Further, in general terms, there are no restrictions applicable to foreign investment in a FIP FMIEE or FII (except that in relation to a FIP only ‘qualified investors’ may invest and the minimum investment value is BRL 300,000)<sup>4</sup>, Individual and/or legal entities located in Brazil or abroad are entitled to invest in quotas of a FIP, an FMIEE or an FII.

#### Foreign exchange controls

There are, however, tight foreign exchange controls that require all transactions between residents and non-residents to be registered with the Brazilian Central Bank’s electronic system (SISBACEN) to enable the remittance of profits and/or interest on equity (*juros sobre capital próprio*) to foreign investors, as well as the repatriation of foreign capital invested in Brazil and the reinvestment of profits and/or interest on equity. These transactions include all direct acquisitions, contributions of shares, intercompany loans, portfolio investments, hedging strategies (e.g., international derivatives) and cross-border payments.

#### *Registration of foreign direct equity investments*

Foreign direct equity investment registration is carried out through SISBACEN by means of electronic registration (*registro declaratório eletrônico de investimentos externos diretos – RDE-IED*). After the foreign currency funds are exchanged into local currency, the Brazilian beneficiary company or representative must electronically register the investment with SISBACEN (both in foreign currency and in the corresponding amount in local currency) within 30 days of the date of receipt of the funds. Registration allows payment of dividends and interest on equity to foreign investors and repatriation of foreign capital invested in Brazil.

#### *Registration of investments in the Brazilian securities market*

In the case of investments performed in the Brazilian securities market, foreign investors normally follow the specific mechanism and requirements of the Brazilian National Monetary Council, which include the appointment of one or more representatives in Brazil through a representation agreement, registration with the Central Bank of Brazil, registration with CVM and execution of a contract for the custody of the securities with an institution authorized by CVM.

---

<sup>4</sup> The definition of qualified investors set out in CVM Rule 409/03 was amended by CVM Rule No. 554 of December 17, 2014 (and will come into force on July 1st, 2015). Among other changes, the financial threshold mentioned above for qualified investors will be increased to BRL 1 million. The same rule (i.e., CVM Rule No. 554) also created the concept of professional investors, which sets out, inter alia, a threshold of BRL 10 million. The new rule also includes non-Brazilian resident investors as both as professional investors and qualified investors.

### *Reinvestments*

Once taxed, and if not remitted abroad to the foreign investor, profits may be reinvested in the same company that generates the profits or in any other Brazilian company chosen by the foreign investor. The reinvestment must also be registered with SISBACEN. The amount of foreign currency registered as reinvestment is determined by the average exchange rate at the date of the relevant reinvestment and published by SISBACEN.

### *Repatriation of capital*

When the foreign investor sells shares or quotas in the Brazilian venture or when the Brazilian company reduces its capital or is liquidated, the foreign investment can be repatriated in the relevant foreign currency free of taxes up to the proportional amount of foreign currency registered with SISBACEN.

For a capital reduction, the amount to be repatriated exceeding the value registered in foreign currency with SISBACEN represents a capital gain and is therefore taxed by withholding income tax income tax deducted at source at the rate of 15%, or 25% if the beneficiary is located in a low-tax jurisdiction (i.e., tax haven country).

If a foreign investor withdraws from its Brazilian subsidiary by assigning its quotas/shares in an amount exceeding that registered with SISBACEN, the exceeding amount will be considered a capital gain and subject to withholding income tax.

### **Financial tax**

Any cross-border remittance of funds from or to Brazil is subject to taxation. The so-called IOF (*imposto sobre operações financeiras*) (i.e., tax on financial transactions) is levied at the rate of 0.38% on the amount transferred as purchase price to the seller or as capital contribution to the purchase vehicle, at the time of the funds transfer. Other rates may apply to different kinds of transaction facilitating the funds transfer (e.g., certain cross-border loans).

## **4. Who are the relevant regulators in the jurisdiction and how much interaction would one generally expect when undertaking a buyout?**

The most relevant regulatory authorities in Brazil are:

- (a) Brazilian Securities and Exchange Commission (CVM);
- (b) BM&FBOVESPA – the São Paulo stock exchange that provides additional regulation for listed entities;
- (c) the competition/antitrust regulator (CADE);
- (d) the Brazilian Monetary Council (CMN); and
- (e) the Central Bank of Brazil.

In addition, there are various regulatory bodies that may become involved, depending on the transaction. These include:

- (a) the authority that regulates activities related to oil, gas and biofuel (ANP);
- (b) the authority that regulates activities related to electrical energy (ANEEL);
- (c) the authority that regulates activities related to aquatic transportation (ANTAC);
- (d) the telecommunications regulator (ANATEL); and



(e) the national department of transports infrastructure (DNIT).

The level of expected involvement of the CVM and BM&FBOVESPA in a buyout depends on whether the transaction involves a publicly listed company (i.e., a public takeover or a scheme of arrangement). Note that the regulatory environment for private equity in Brazil is experiencing a period of expansion and change, which means that it is necessary to closely observe the regulatory developments. As a general trend, regulators are becoming more familiar with the issues involved in private equity transactions, and there is increasing transparency in market practices.

## 5. How are buyouts typically undertaken in the private and the public markets?

### Private companies

In a private context, transactions are usually undertaken by way of negotiated acquisition. That is, negotiated sale and purchase documents are prepared, negotiated and executed and those documents record the terms of the sale and acquisition, and the rights and liabilities of the parties.

Private acquisitions are regulated by the Civil Code and/or by the Brazilian Corporations Law (**Corporations Law**).

### Public companies

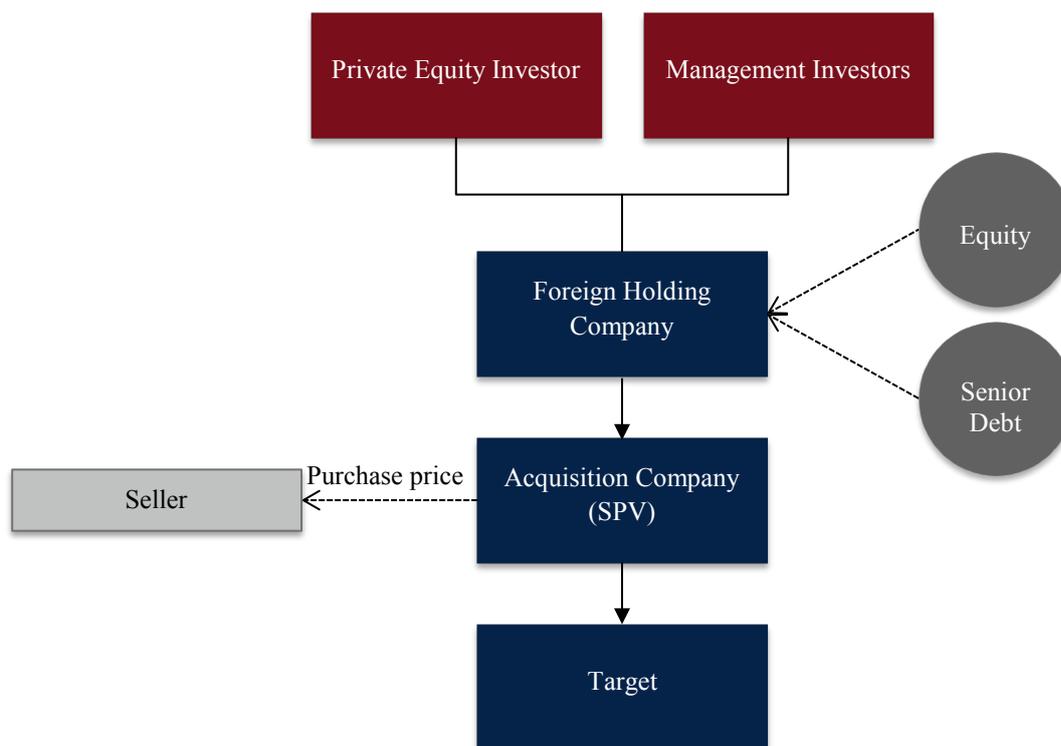
In general, control of the shares in a Brazilian publicly-held corporation is often also acquired through a private transaction between the interested acquirer and the controlling shareholder(s), as Brazilian companies participating in the capital market usually keep a high percentage of their voting shares out of the free float (and, therefore, in the hands of a controlling group).

Although takeover public offers are not yet common practice in Brazil, the Corporations Law allows the acquisition of the share control of a publicly-held corporation by third parties through a public offer, provided that it is made to all holders of the voting shares (and subject to certain limitations on the number of shares that may be acquired).

Note that in addition to the Corporations Law, public acquisitions are subject to CVM's regulations.

## 6. What is the typical corporate structure used when doing a buyout?

This diagram reflects the typical private equity investment structure in Brazil.



Transactions are usually structured in such a way that a group of funds, financial institutions and/or a strategic investor will acquire control of a target company. The acquisition is typically through a two-tiered holding company structure whereby the local Acquisition Company SPV will consolidate the investments from the acquirer. Note that debt finance will generally not be injected at the local Acquisition Company SPV level due to the high interest rates applied to loans sourced locally. The Acquisition Company SPV is usually merged into the Target once the transaction closes to provide better cost-efficiency and, if applicable, goodwill amortization.

LBOs are rather uncommon because of the high interest rates in Brazil. Investors will usually therefore secure loans from foreign markets (through a foreign holding company) with better interest rates rather than obtain the loans locally. This means that:

- (a) mezzanine financing is rarely used in the Brazilian market (unsecured loans would have even higher interest rates and that would make it very difficult for the transaction to be economically attractive); and
- (b) the debt is usually concentrated in the foreign acquisition vehicle rather than in the holding company/target company (although, in isolated cases we have seen borrowings that were allocated to the target company/Acquisition Company).

Management is usually involved as a key participant rather than as an investor (i.e., generally the transaction results in management changes (people and policies) to improve the management of the business and its results. However, management buyouts per se are even rarer than standard LBOs in Brazil).



## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

For buyouts negotiated in a private context, the primary legal document that records the transaction is the sale and purchase agreement. There may also be other ancillary transaction documents prepared depending on the nature of the deal. These can include:

- (a) a shareholders agreement (negotiated with sellers to the extent they continue their participation in the business). Note that for private buyouts, the shareholders agreement does not need to be filed publicly. However, for publicly listed companies, the shareholders agreement must be disclosed publicly under the CVM's information disclosure rules;
- (b) a transition/shared services agreement; and
- (c) commercial agreements (if there are strategic investors) (e.g., agreements with past controlling shareholders and transitional services arrangements).

For buyouts negotiated in a public context, the primary legal document which records the transaction is generally a sale and purchase agreement entered into with the controlling shareholder. This is common because of the highly concentrated capital structure of the Brazilian market. Additionally, it is important to note that negotiations in the Brazilian securities market for the acquisition of control may trigger the requirement to provide a mandatory tender offer to all holders of common shares for 80% of the price paid to the controlling shareholder or an equal price.

### Banking

The banking and security documents greatly depend on the structure of the deal. The documents usually include a loan agreement and may also include ancillary guarantees, a pledge of shares, a personal guarantee from the parent company of the acquirers and a guarantee over the assets or revenues of the target company.

Depending on the private equity structure used, different banking regulatory concerns and structures may arise. Foreign exchange rules apply in all cases involving foreign investors. As discussed above in the answer to question 3, Brazil has a regulatory framework that governs inflows and outflows of foreign capital that must be observed by foreign investors.

## 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

Private equity funds usually invest through straight equity structures (i.e., by the acquisition of shares rather than through debt instruments), without additional protection or guarantees, except the usual protections used in M&A deals. These usual protections include standard buyer protections such as negotiated warranty and indemnity coverage from the seller (being either the shareholders in a share sale or the company from which the business and assets are being acquired).

The terms of the coverage vary from transaction to transaction although it is quite normal to expect that limits are placed in relation to any coverage of this type, including claim thresholds and caps, time limits and adjustments for items otherwise disclosed or accounted for. Other types of guarantees, such as placing funds in escrow, holding back part of the purchase price, mortgages and pledges are also common.

Warranty & indemnity insurance, albeit rarely used in transactions in Brazil to date, is not unheard of because there is more awareness developing and brokers are showing interest in the Brazilian market.

It is, however, currently more common to have negotiated indemnification provisions with the seller and escrow accounts or other guarantees.

## 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

### Management

Management owes the company duties of care and loyalty and must also disclose any equity interest or other securities held in the target company. Management must also avoid any conflicts of interest in relation to the company or any situations that may lead to a conflict of interest, and promptly properly record and disclose those circumstances to the company.

Brazilian publicly-traded corporations are also subject to CVM rules. For example, administrators must notify the CVM, the company and the stock exchange on which the company is listed about the acquisition or trading of the company's securities. Moreover, the administrators of a publicly-held corporation must inform CVM, the relevant stock exchange where the company is listed and the general public about any corporate resolution or material fact that has surfaced within the company's business that may significantly impact the decisions of other investors about whether to buy or sell that company's securities.

The Corporations Law also prohibits the appointment to the company of officers and directors who have a conflict of interest with the company, unless the shareholders' meeting waives this prohibition. On appointment to management, the individual must execute an affidavit stating that he or she does not have a conflict of interest with the company, as defined under the applicable rule. Further, the target company may ask the manager to sign an undertaking committing not to hold equity interests in competitors of the target or otherwise compete with the target in any manner.

### Investment funds

There are also rules dealing with conflicts of interest in investment funds. The administrators of investment funds (e.g., FIPs, FIEEs and FIIs) are obliged to disclose material acts or facts that may impact significantly on the decisions of the investors about whether to buy or sell the funds' securities.

## 10. How are the equity arrangements typically regulated in a buyout?

The equity arrangements in a typical buyout are regulated primarily by a shareholders agreement or a quota holders agreement, depending on the target's corporate structure. Additionally, the relevant company's constitutional documents will include specific share/quota rights attaching to the relevant classes of security.

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

### FIP, FIEE and FII

The quotas of a FIP may grant different voting rights, but must grant the same economic rights to all of the investors (except that different fees, including performance fees, may be payable to the administrator of the fund by the different classes of quotas in accordance with the provisions of the fund's charter).

The quotas of an FIEE and of an FII may not grant different voting or economic rights.



## SA

The capital of an SA can be divided into shares that may confer different voting and economic rights. Depending on the rights attached to the shares, the shares may be classified as common or preferred.

Common shares (voting shares) may be divided into classes with different rights, for example:

- (a) the right to convert the common shares into preferred shares;
- (b) a requirement that their holders be Brazilian citizens (e.g., if the target company requires a certain level of national ownership in a regulated sector); or
- (c) the right to vote in relation to the appointment of administrators in a separate election.

Preferred shares may be issued without voting rights or with restricted voting rights. Preferred shares of non-listed corporations grant to their holders priority in the distribution of a fixed or minimum dividend, and/or priority in the reimbursement of the corporate capital with or without premium in the case of the liquidation of the company. Non-voting preferred shares may be issued up to the limit of 50% of the company's total issued shares.

## Ltda.

The quotas of an Ltda. may grant different economic rights but the voting rights at the meetings/resolutions of the Ltda. are based on the amount that quota represents in the corporate capital of the company.

## Other

Different levels of shareholding in the various structures of Brazilian companies entail different rights and obligations to the corresponding shareholder. For example, holders of at least 15% of the voting shares of a listed corporation are entitled to request a separate vote for the election of one member of the board of directors and his or her alternate in a separate meeting in which the controlling shareholders and their related parties would not be entitled to participate. These rights need to be carefully examined on a case-by-case basis.

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

### Funds

#### *General*

In general, two key management roles exist in relation to the governance structure of funds:

- (a) the administrator of the funds, which may be a legal entity or, if permitted, an individual, is responsible for, among other things, the management of the fund, the release of information to stockholders, hiring of independent audit companies and managing the internal activities and financial controls of the fund; and
- (b) the portfolio manager, which may be a legal entity or an individual, is responsible for the business and investment decisions of the fund, being generally permitted to perform the acts related to the investment (buying, selling or exercising rights under the investment).

Generally, the administrator is responsible for the organization of the fund and approval of its organizational documents. Once the fund has been formed, the stockholders will be allowed to dismiss and replace the administrator, at any time, by means of a majority decision at a stockholders' meeting. The administrator will also be allowed to resign from its position, but this resignation is usually accompanied by a prior notice (e.g., a minimum 60 days prior notice in the case of an FMIEE)

and the obligation on the administrator to ensure that a meeting is held to elect its replacement and the adequate transfer of the management activities to the new manager.

The portfolio manager, in turn, is generally appointed by the administrator of the fund and the administrator of the fund may also replace the portfolio manager. In the absence of a portfolio manager, its rights and powers are exercised by the administrator of the fund.

#### *FIP*

A FIP must be administered by a legal entity registered and authorized by CVM for the performance of professional portfolio management services. If the administrator is not a financial institution member of the Brazilian securities distribution system, it must retain an institution member to perform the services relating to the distribution of quotas and treasury. The administrator of the FIP may also retain a portfolio manager if it is also registered and authorized by CVM. If retained, the manager's main duty is to decide on the investments to be carried out by the fund and to make decisions in relation to the sale of the fund's assets.

#### *FMIEE*

The administration of an FMIEE may be performed by an individual or a legal entity (either a financial or a non-financial institution), duly authorized by the CVM to manage securities portfolios. If the administrator is not a financial institution member of the Brazilian securities distribution system, it must retain an institution member to perform services relating to the distribution, issue and redemption of quotas and treasury.

#### *FII*

The management of an FII is external and the administrator must be:

- (a) a commercial bank;
- (b) a full operational bank with an investment portfolio or with a real estate credit portfolio;
- (c) an investment bank;
- (d) a brokerage firm or distributor of securities;
- (e) a real estate credit company or saving bank; or
- (f) a mortgage company with the required licenses to operate as a mortgage company.

### **Portfolio companies**

#### **SA**

The administration of the SA must be carried out by the shareholders' meetings, the board of officers (management body responsible for the day-to-day management and the sole body with powers to represent the company) and, if applicable, by a board of directors (a decision making body responsible for directing the business of the company).

The board of officers must be comprised of at least two members, who must be resident in Brazil. The board of officers must be elected by the board of directors, by a majority of votes, or, if there is no board of directors, by the shareholders at a shareholders' meeting by a majority of votes.

A board of directors is only required if the SA:

- (a) trades its securities on the stock exchange or in the over-the-counter markets;
- (b) offers debentures to the general public; or



- (c) has an authorized capital.

If required, the board of directors must be composed of at least three directors who may, but are not required to, be shareholders. Members of the board of directors are elected by the shareholders, at a shareholders' meeting, by a majority of votes.

Brazilian residency is not a requirement to hold a position as a member of the board of directors. Nevertheless, an attorney-in-fact resident in Brazil must be appointed to receive service of process on behalf of the non-resident director, and that appointment must remain valid for at least three years after the end of the term-of-office of that non-resident director.

Members of both the board of directors and the board of officers may be removed by the majority of votes cast at the meeting of the management body with powers to elect them (i.e., the shareholders' meeting in relation to members of the board of directors and the board of directors' meeting in relation to members of the board of officers), although the bylaws may require a larger quorum.

#### *Ltda.*

An Ltda. must be managed by at least one officer who is resident in Brazil appointed directly in the articles of association/bylaws or in a separate document. When the officer is not a quota holder of the Ltda., the approval of a minimum of two-thirds of the company's capital is required when the capital is fully paid in. If the capital is not fully paid in, all partners must agree on the appointment.

If the officer is also a quota holder of the Ltda:

- (a) when the election is made based on a separate document, the approval of more than half of the corporate capital is required; and
- (b) when the election is made based on the articles of association, the approval of least three-quarters of the corporate capital is required.

To dismiss an officer appointed by a separate document, quota holders representing more than half the corporate capital must agree (whether or not the officer is a quota holder himself or herself). To dismiss an officer appointed by the articles of association:

- (a) if the officer is not a quota holder, holders of at least three-quarters of the corporate capital must agree; and
- (b) if the officer is a quota holder, holders of at least two-thirds of the corporate capital must agree.

### **13. What measures are commonly used to give a fund some level of control over key operating and financial decisions made by an investee company?**

Measures commonly used to give a fund some level of control over key operating and financial decisions made by an investee company include:

- (a) holding shares that are part of the controlling block of the company;
- (b) holding shares of a class that confer veto rights concerning operating and financial decisions;
- (c) execution of a shareholders agreement; and
- (d) execution of any agreement that assures effective influence in the administration of the investee/target company.

## 14. What employment terms are generally imposed on management in a buyout?

It is common for senior members of a management team in a buyout to enter into an employment agreement. Although these types of agreements may provide for a fixed employment period, the manager still has the ability to leave his or her employment before that term elapses. Some of these agreements include an obligation on the employee to indemnify the employer for the remainder of the employment period that was not worked, but success for the employer in relation to this type of claim is not guaranteed. Alternatively, it is possible to enter into agreements that set out additional compensation bonuses that are conditional on the continuation of the manager in the company for a determined period of time. These types of provisions however should be carefully considered on a case-by-case basis in relation to Brazilian labor laws. Non-competition provisions are also acceptable, subject to some limitations on duration.

It is also common for remuneration under these agreements to include a fixed component and a bonus component related to performance.

## 15. What incentives can be offered to management and how are they typically structured?

The incentives for management of listed SA investee companies generally take the form of equity (unrestricted stock) or options over equity. For non-listed companies they generally take the form of direct monetary compensation and bonuses subject to certain performance criteria.

In case of equity or options over equities, management is expected to pay for its equity, but it may be structured in a way that allows the manager to put his or her equity up for sale in the market and utilize the proceeds for the payment of the equity (with the terms of the stock option usually allowing payment of the option price within a few days after the acquisition of the shares, therefore allowing the manager to utilize the proceeds from the sale of the vested shares). Note further that any options must have a risk component and may not have a guaranteed profit attached to them (e.g., an option with an exercise price equal to the market price at the time of exercise with a discount is not allowed).

In certain cases, management equity plans are adopted to regulate the way in which management equity is issued. This can include earning or vesting of the equity over a period subject to the achievement of agreed financial hurdles and can be reacquired by the portfolio company if a manager ceases to be employed for any reason. The structure needs to be carefully considered based on limitations in relation to the trading by a company of its own securities under Brazilian law. Good leaver and bad leaver provisions are also common, either in the shareholders agreement or the relevant plan terms.

The company may, however, agree with the manager that if they leave on certain terms, they may have a put-option to sell their shares, the value of which is calculated determined using a certain valuation method applicable to withdrawing shareholders who exercise exit rights. This usually cannot be lower than the share's net worth value as determined in the last balance sheet but it may determine a valuation based on the economic value. This may be relevant if the company's stocks do not have much liquidity; otherwise, the manager may sell their shares on the market at market value. In the case of listed companies, the manager cannot be completely prevented from disposing of their shares.

## 16. How are buyouts typically debt financed and secured?

At the investee/portfolio company level, generally the first step after the buyout is to leverage the invested company using debt provided by banks and financial institutions. The amount of debt that can be raised is typically calculated as a multiple of the earnings of the target business. Brazil has a large number of domestic and international banks and financial institutions willing to participate in



leveraged finance deals. Lenders usually expect the equity to be structurally subordinated to the debt finance with the debt being lent to a special purpose finance company which is a wholly owned subsidiary of the holding company. Recent changes made to regulations applicable to FIPs allow the manager to grant security in the name of the FIP, if a qualified majority of its shareholders approve the transaction, and that authority is provided for in the FIP's charter documentation.

At the fund level, FMIEEs and FIIs may not borrow funds. FIPs may borrow funds within the exceptions authorized by CVM.

## 17. Are there financial assistance issues to consider when undertaking a buyout?

Under Brazilian statutory laws applicable to companies incorporated in Brazil, there may be restrictions on a Brazilian company to provide financial assistance for the acquisition of its own shares or shares of its parent company. For example, the law sets out general principles on the acquisition of own shares by a Brazilian company, abuse of the power of a controlling shareholder, conflict of interests and minority shareholder and creditor rights which may restrict the granting of financial assistance. Brazilian securities market rules also prohibit a company from incurring any costs related to a tender offer for the acquisition of its own shares, unless the tender offer has not been launched directly by the company.

Considering the above, possible transactions involving financial assistance by a Brazilian company should be analyzed on a case-by-case basis depending on the structure and type of financial assistance being provided.

Note also that FIPs, FIEEs and FIIs are prevented from granting loans or granting security.

## 18. What are the implications under the corporate benefit laws of Brazil for a company providing financial assistance?

There are no corporate benefit laws in Brazil that could guide a company when providing financial assistance. Brazilian laws do, however, impose limitations on the managers, officers and/or directors of companies and corporations (**Administrators**) when undertaking obligations on behalf of those companies and corporations and Administrators may face civil and/or criminal liabilities in relation to the performance of their duties in breach of these rules.

The Corporations Law sets out detailed rules in relation to civil liability of Administrators. Section 158 of the Corporations Law states that an Administrator will not be held personally liable for the obligations undertaken on behalf of the corporation in the performance of regular managerial acts. However, the Administrator will be liable for damage arising from acts performed within one's attributions or powers through negligence, willful misconduct or in violation of the law or the company's articles of association or bylaws.

In the performance of their duties, Administrators owe a duty of loyalty and of care, and therefore need to seek to act in the best interests of the company. If an Administrator is found to be civilly liable for damage to a company, the Administrator's personal assets may be seized to seek to remedy the damage caused. If an Administrator is found to be criminally liable he/she may be punished for the relevant acts that are considered to be a crime according to criminal laws.

In addition, depending on the actions that have been performed, if it is identified as an abuse of form by way of deviation from the corporation's purpose or confusion between the assets of the corporation and those of its Administrators or shareholders, the 'corporate veil' of the company may be 'pierced' and the assets of the Administrators and shareholders may be seized to seek to remedy the damage caused to third parties.

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

Debts in relation to employee rights and payment to a government controlled severance fund outrank any other debts in a bankruptcy proceeding, limited to 150 minimum wages per employee (currently corresponding to BRL 108,600). The remaining portion of overdue salaries will be treated as unsecured debts and paid in the order below. After the payment of the employment debts, the secured debts (i.e., those debts secured by one or more ‘real’ guarantees), up to the value of the guarantee, are satisfied next. After payment of the secured creditors (up to the limit of their guarantees), the assets of the bankrupted individual/entity will be used to pay tax debts.

After all labor, tax and secured obligations have been fulfilled, the insolvent entity must pay the remaining debts in the following order:

- (a) debts with special privilege;
- (b) debts with general privilege;
- (c) unsecured debts; and
- (d) subordinated debts (i.e., debts are the debts of the managing partners, controlling shareholders, managers and other administrators (in addition to any other debts defined as such by law or by contract).

Note that all expenses in relation to the judicial reorganization or bankruptcy proceedings, such as the judicial administrator’s fees and the incident taxes to those proceedings, will not be subject to the regime of preferred creditors. This means that they will be paid before any other debts against the insolvent individual/entity.

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

The form of the entity that is used is a key factor in determining the overall tax treatment of the structure. A key issue is whether the relevant entity is considered a legal entity for Brazilian tax purposes (for example, a Ltda or an SA is considered a legal entity for Brazilian tax purposes whereas a Brazilian fund, except in certain cases, is not).

### Stamp duty

There is no stamp duty in Brazil, including in the case of acquisition of shares and/or quotas of a Brazilian entity.

### Financial transactions tax

In addition, as a general rule, any remittance of funds from, and to Brazil, is subject to the Brazilian financial transactions tax called IOF (*imposto sobre operações financeiras*). The IOF rate may vary from 0% to 25% by federal decree (a type of law that may be enacted by the Brazilian Federal President). Currently, the general rates of the IOF range from 0% to 6% for investments carried out on the stock exchange and private buyouts.

### Deductions

Brazilian tax legislation provides rules and conditions for deduction of expenses incurred by a Brazilian legal entity. In general, expenses are deductible if they are considered:

- (a) necessary for the activities performed by the legal entity or related to the maintenance of the productive source; and



- (b) usual or normal for the type of business carried out by the company.

In general, Brazilian tax legislation provides that the interest paid or credited by taxpayers is considered deductible as a cost or operational expense. However, there are specific rules applicable to transactions between related parties, such as the thin capitalization and transfer-pricing rules as further explained below.

#### *Transfer pricing*

To the extent that the Brazilian entity (borrower) pays interest to foreign related parties, the Brazilian transfer-pricing regulations may impose certain limitations in relation to interest deductibility if the loan is not properly registered with the Central Bank of Brazil. This is because, as a general rule, the loans must be registered with the Central Bank of Brazil, generating a Financial Operation Register (**ROF**) and a ROF number.

Brazilian tax legislation establishes new transfer pricing interest rates parameters that must be followed by Brazilian taxpayers in the computation of Brazilian corporate taxes (currently 34%). These rates will apply to all credit transactions if the counterparty is located in a low or privileged tax regime jurisdiction, or if the counterparty is a related party. The new parameter rates apply not only to loans but to all other types of international debt transactions.

#### *Thin capitalization*

As mentioned above, thin capitalization rules place limitations on the deductibility of accrued interest due to foreign related parties and/or with lenders domiciled in low tax jurisdictions or subject to privileged tax regimes. In relation to the payment of interest paid to foreign related parties, the debt/equity ratio applicable for deductibility purposes is 2:1.

Note, however, that the applicable ratio is decreased to 0.3:1 for parties subject to a privileged tax regime or domiciled in low tax jurisdictions. Further, in addition to the more restrictive ratio, such parties are also subject to the following conditions regarding deductibility of interest expenses:

- (a) the beneficial owner of the income must be identified;
- (b) proof of operation capacity of the foreign recipient; and
- (c) written evidence of the payment of the price and of the receipt of the goods, assets or rights related to the interest payments.

Irrespective of whether these conditions are met, interest paid or credited by a Brazilian source to related legal entities or individuals residing or domiciled in regular (as opposed to low) tax jurisdictions, will be deductible within the fiscal year for the purposes of calculating the corporate income taxes if they meet the following requirements:

- (a) if the foreign party has an interest in a Brazilian corporate entity, the debt funding verified by means of the average monthly balance must not exceed two times the amount of equity participation of the related foreign party in the net equity of the Brazilian entity; and
- (b) if the foreign party does not hold a direct interest in the Brazilian corporate entity, the sum of the debt funding verified by means of the average monthly balance does not exceed two times the amount of the net equity of the Brazilian entity.

In both cases listed above, the sum of the debt funding from related parties abroad at the time of the computation of the interest expense must not exceed two times the total participation of all related parties in the net equity of the Brazilian entity.

In addition, for purposes of calculating the total debt funding, every form and term of financing must be taken into account, including the registration with the Brazilian Central Bank. We must emphasize

that the thin capitalization rules are also applicable to debt funding transactions raised by Brazilian entities by which the guarantor, legal representative or any intervening party is a foreign related party or a party domiciled in a low tax jurisdiction or subject to a privileged tax regime.

## Capital gains tax

The acquisition of shares generally triggers capital gains tax as there is no stamp duty in Brazil. The combined corporate income tax and social contribution rate generally applicable to capital gains of Brazilian entities is currently 34%. If the capital gain is recorded by an individual resident in Brazil, the tax rate will be 15%. It is common to see sellers reorganizing the corporate structure of the target company pre-closing to ensure individuals are the entities selling the shares rather than a holding company.

In the case of a share sale of a Brazilian entity by a non-resident shareholder, a 15% withholding income tax normally applies on the gain incurred on the sale (except if the non-resident seller is domiciled in a low tax jurisdiction, in which case the withholding income rate is increased to 25%).

Note that no withholding income tax is levied on the sale of the shares if the sale transaction is carried out on the stock exchange.

## Depreciation of goodwill

From a Brazilian tax standpoint a buyer (that is a Brazilian legal entity) may benefit from the tax amortization of the goodwill paid in relation to a stock acquisition, provided certain conditions are met. To benefit from the tax amortization of the goodwill, the acquisition must be followed by a merger of the Brazilian target company into the Brazilian buyer (acquisition vehicle), or vice-versa. This goodwill must also be justified based on the expectation of future profits and supported by an appraisal prepared by the time of the acquisition. After the merger, the goodwill can be amortized at the surviving entity level up to the limit of 1/60 per month (within a term of 5 years). Other types of goodwill and amortization rules may apply, depending on the case.

## Taxation of FIPs and FMIEEs

Currently, neither FIPs nor FMIEEs are subject to taxation in relation to the acquisition and disposal of investments in Brazil. In addition, the income received from those investments is normally not taxed at the FIP and the FMIEE level. Conversely, the portfolio companies of a FIP or FMIEE are subject to all Brazilian taxes applicable to a standard legal entity.

The payment of income from the FIP (or FMIEE) to the foreign investor (i.e., the holder of quotas of the Brazilian FIP or FMIEE) is normally subject to Brazilian withholding tax and the rates normally vary from 0 to 15%. In other words, the withholding tax is levied at the time of the effective disposal of income to the investors (redemption or liquidation of quotas).

The mentioned 0% rate applies when the beneficiary is a foreign investor, except in the following circumstances set out in the tax legislation:

- (a) if the shareholder, alone or together with related parties, represents 40% or more of all shares issued by the fund;
- (b) if funds hold in their portfolios, at any time, debt in excess of 5% of its equity percentage (except the limit debt securities and public securities); and
- (c) a person is resident or domiciled in a low tax jurisdiction.

The capital gain incurred by the foreign investor on a sale of the quotas of the FIP (or FMIEE) is subject to the 0% rate.



## Taxation of an FII

In contrast to the FIP and FIEE, investments carried out by an FII are taxed at the fund level. The general rule is that all investments are taxed at the fund level, except for those specifically set out in the legislation. The tax in this case may be offset against withholding tax applicable when the FII distributes income to its quota holders.

Also, the FII will be taxed as a legal entity if it invests in a real estate development where the developer, the main contractor or the partner is a quota holder that holds, individually or jointly with a related party, quotas representing 25% or more of all the FII's quotas.

The payment of income from the FII to the foreign investor (i.e., the holder of quotas of the Brazilian FII) is normally subject to Brazilian withholding tax at the rate of 15%.

The capital gain incurred by all foreign investors on a sale of the quotas of the FII are subject to Brazilian income tax at 0%, except for foreign investors resident or domiciled in a low tax jurisdiction.

## 21. What forms of exit are available?

Exit vehicles in Brazil include private sales and initial public offerings (IPOs). Private sale is the most common exit mechanism in Brazil used by private equity funds.

## Canada

### 1. What structures do private equity funds typically use to manage their funds?

In Canada, private equity funds are typically managed using a limited partnership structure. Under this type of structure the investors hold limited partnership interests in the partnership and there is a general partner that takes control of the day-to-day management and control of the partnership and its operations. Limited partnerships are formed under provincial laws and are typically a look-through entity for Canadian tax purposes. As such the limited partnership itself is not taxed. Rather the limited partners will be taxed on income allocated to them by the limited partnership.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in Canada?

Certain provinces and territories require limited partnerships and their general partners to be registered with the relevant provincial ministry for partnership law purposes.

In addition, if the fund has limited partners who are resident in Canada, the general partner may be considered a 'fund manager' under the applicable provincial securities legislation and subject to the fund manager registration requirements. The distribution of limited partnership securities may also attract dealer and adviser registration requirements.

### 3. Are there any approvals required for investments by foreigners in Canada and, if so, what is the process?

#### Foreign investment approvals and notifications

Foreign investment in Canada is regulated by the Investment Canada Act (**ICA**). Generally speaking, the ICA monitors the establishment of new businesses and the acquisition of control of existing Canadian businesses by non-Canadians.

Whether an entity is a non-Canadian for the purposes of the ICA is determined by the nationality of the individual who ultimately beneficially owns or controls the entity. Every non-Canadian who is a citizen or resident of a country that is a member of the World Trade Organization (**WTO Investor**) is given special status under the ICA for most transactions. The rules to determine whether an entity or individual is a WTO Investor can be complicated and should be analyzed on a case-by-case basis.

#### Notifiable acquisitions

A non-Canadian establishing a new business in Canada must file a notification with the Investment Review Division of Industry Canada (**IRD**) prior to, or within 30 days of, the commencement of the business. This filing is unnecessary if the new business is related to a Canadian business already being carried on by the foreign investor.

A notification must also be filed with respect to each direct acquisition of a Canadian business if the book value of its assets is less than CAD 369 million (for 2015), unless neither the seller nor buyer of the Canadian business is a WTO Investor.

A transaction will be reviewable if the book value of the assets is CAD 5 million or more and if the Canadian business relates to Canada's cultural heritage or national identity, or if neither the seller nor the buyer is a WTO Investor. Furthermore, if the new business or the business of the target is related to Canada's 'cultural heritage or national identity', the Minister of Canadian Heritage may exercise discretion to review it, regardless of its size. The applicable regulations define 'cultural heritage or national identity' to include the publication and distribution of books, magazines, periodicals,



newspapers, films, videos, music recordings and sheet music, and radio, television and cable television broadcasting and related activities. The Department of Canadian Heritage conducts the review process for these transactions.

### Reviewable acquisitions

Acquisitions that are subject to review cannot generally be completed until approval is received. Direct acquisitions of control of a Canadian business whose gross assets exceed CAD 369 million (for 2015) would require approval. This approval is given on application if the Minister is satisfied that the acquisition will result in a 'net benefit' to Canada. The approval process may take as long as six weeks.

As a condition of approving a reviewable transaction, the IRD on behalf of the Minister of Industry (or the Minister of Canadian Heritage, as the case may be) often requires undertakings from the non-Canadian to ensure that the transaction is of net benefit to Canada. Compliance with these undertakings is monitored after closing the transaction and will be renegotiated if they have not been substantially performed.

### Investment by foreign state-owned enterprises

The Canadian Minister of Industry has issued guidelines specifically relating to investments involving foreign state-owned enterprises that will normally be subject to scrutiny and post-transaction obligations with respect to governance and commercial focus. However, these apply only to investments that are subject to a pre-closing review.

### National security

The Minister of Industry has very broad powers to examine any investment in Canada (whether or not subject to review or notification under the above requirements) made by a non-Canadian if the Minister reasonably believes that the investment could be injurious to national security. A transaction cannot be closed without approval if the Minister has given notice to the non-Canadian prior to implementation that he has concerns relating to the investment's impact on Canadian national security. If the transaction has already closed, the federal cabinet may order divestiture. The term 'national security' is not defined and to date virtually no guidance has been provided in relation to how this provision will be interpreted or implemented.

### Real property

In most provinces and for most property interests, there is no restriction on the ownership of real property in Canada by non-resident persons or corporations, with a few exceptions:

- (a) in Prince Edward Island, a non-resident may not own land in excess of five acres or having a shore frontage in excess of 165 feet (unless the non-resident first receives permission to do so from the Lieutenant Governor in Council);
- (b) Alberta restricts non-resident ownership of controlled land (land outside the boundaries of a city, town, new town, village or summer village);
- (c) Saskatchewan restricts the sale of agricultural land to non-residents to 10 acres; and
- (d) Manitoba restricts non-residents from owning more than 40 acres of farmland and requires that they move to the province within two years of purchasing the land.

Non-residents may apply for an exemption from the Alberta, Saskatchewan and Manitoba restrictions, and Canadian citizens and permanent residents (and corporations controlled by them) are not subject to the Alberta, Saskatchewan and Manitoba restrictions.

- (e) Québec does not permit non-residents to purchase agricultural land without permission from the *Commission de protection du territoire agricole du Québec*. A non-resident is anyone who has lived in Québec for less than 366 days within the 24 months preceding a real estate transaction. Québec also restricts ownership by non-residents of certain classified cultural properties.

### Industry-specific regulation

Other federal statutes regulate and restrict foreign investment in industry sectors, such as telecommunications, broadcasting and banking. The Competition Act requires notification of transactions that exceed the following financial thresholds, regardless of whether they are likely to have any anti-competitive effects:

- (a) either:
  - (i) the assets in Canada; or
  - (ii) the annual gross revenues from sales in, from or into Canada of the purchaser and its affiliates and the target and its affiliates combined,

exceed CAD 400 million; or

- (b) either:
  - (i) the aggregate value of the assets in Canada of the target; or
  - (ii) the annual gross revenues from sales in or from Canada ‘generated from [those] assets’

exceed CAD 82<sup>5</sup> million; and

- (c) the purchaser (and its affiliates) would own more than 20% of the voting shares if the target is a publicly traded company.

In addition, the target must be an ‘operating business’, which is defined as ‘a business undertaking in Canada to which employees employed in connection with the undertaking ordinarily report for work’.

Both the purchaser and the target corporation make the pre-notification filing, if required. There is one filing fee of CAD 50,000. The Commissioner of Competition may, within 30 days following receipt of the filing, send a notice to the party that supplied the information requiring it to provide additional information. Once all of the information is received a second 30-day waiting period begins.

The Competition Bureau also has the authority to review transactions that do not meet the financial thresholds but where there are substantive competition concerns for a period of one year after closing.

## 4. Who are the relevant regulators in Canada and how much interaction would one generally expect when undertaking a buyout?

### Corporate registrars

The federal government and each province have a corporate registry and regulation department. This department which has various names depending on the province where it is located, oversees the granting of business registrations and licenses as well as administering the applicable provincial and federal business corporations legislation.

---

<sup>5</sup> This threshold changes on an annual basis.



## Competition Bureau

The Competition Bureau is an independent law enforcement agency. Its mandate is to protect and promote competitive markets. Headed by the Commissioner of Competition, the organization investigates anti-competitive practices and promotes compliance with the laws under its jurisdiction. In the buyout context, interaction with the competition bureau is likely to be limited to the investment review process under the Competition Act.

## Securities commissions

Canada does not have a federal securities regulatory authority. Instead each of the Canadian provinces and territories has enacted its own securities regulatory regime. Despite this provincially regulated structure, the basic regulatory concepts are reasonably equivalent across the country. The securities commissions are mandated to regulate registration of market participants such as investment dealers, investment advisers, market intermediaries, issuers of securities, and to oversee the protection of investors in securities. In the context of a buyout of a Canadian listed company, the acquirer can expect to be involved with the securities commission in each of the provinces where the target company's shareholders reside.

## 5. How are buyouts typically undertaken in the private and the public markets?

### Private companies

In a private company context, transactions are usually undertaken by way of negotiated acquisition. That is, negotiated sale and purchase documents are prepared, negotiated and executed and those documents record the terms of the sale and acquisition and the rights and liabilities of the parties.

### Public companies

In the case of a public target company, buyouts can be undertaken as a negotiated acquisition with the target company's shareholder approval, by a takeover bid (sometimes called a tender offer) or through a plan of arrangement or merger transaction.

#### *Takeover bid*

The federal and provincial corporations acts and the provincial securities statutes set out the procedure by which a takeover bid can be made for a voting interest greater than 20% of a public company. Those considering acquiring a controlling interest in a Canadian public company need to be aware of the early warning disclosure obligations which apply to arm's length acquirers once they have acquired more than 10% or more of a public company's equity voting securities of any class. The takeover bid is required to remain open for a statutorily prescribed minimum 35 days and each amendment usually requires a minimum 10-day extension.

#### *Plan of arrangement*

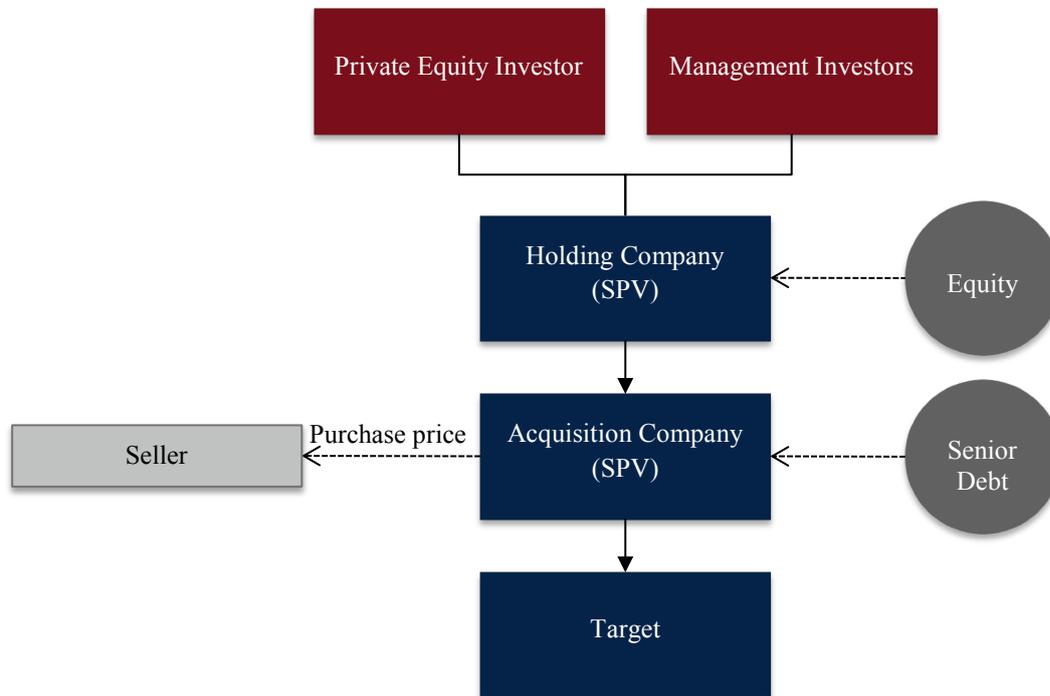
A plan of arrangement is a statutory procedure available under the federal and many of the provincial corporations statutes. Where a corporation wishes to combine (merge) or to make other 'fundamental changes' but cannot achieve the result it wants under another section of the statute, it can apply to the court for an order approving a 'plan of arrangement'. The flexibility of the plan of arrangement process can permit a company to undertake what would otherwise be a complex multistage transaction in a single step. Usually a court requires the public company's shareholders to approve the transaction before the court will approve the plan of arrangement.

### Amalgamation (merger) transaction

Another possible transaction structure involves the amalgamation (merger) of a Canadian acquisition company with the target public company. This type of transaction will require 66⅔% of the public company's shareholders to approve the amalgamation.

## 6. What is the typical corporate structure used when doing a buyout?

Although acquisition structures vary from transaction to transaction, it is fairly common to see a two-level holding company structure adopted along the following lines:



This type of structure allows for the senior debt financing to be provided to the special purpose vehicle incorporated as the acquiring company (Acquisition Company SPV), while the equity contribution from the private equity fund or funds is contributed at the holding company level and subsequently contributed down to the Acquisition Company SPV in the form of unsecured loan funds or equity. More elaborate structures invariably exist in relation to larger more complex deals, particularly where any debt funding involves mezzanine funding sources that may need to be structurally subordinated to the senior financiers but rank ahead of any equity contributed by the private equity fund or funds.

## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

In addition to the relevant corporate authorizing resolutions, in a buyout negotiated in a private company context, the primary legal document that records the transaction is invariably the sale and purchase agreement. There may also be other ancillary transaction documents prepared depending on the nature of the deal. These can include:

- (a) a transition/shared services agreement;
- (b) non-competition agreements with the vendor and key personnel; and



- (c) any specific documents required to legally effect the transfer of title to the shares or assets, as applicable.

In the event of a takeover bid, the acquirer would prepare a takeover bid circular as required by the applicable provincial securities regulations. This circular is sent to each shareholder of the target public company setting out certain mandatory disclosure as well as the terms of the proposed offer to purchase.

In the case of a plan of arrangement, an arrangement agreement is negotiated between the parties who would then apply to a court for an 'interim order' that will direct the target public company to give notice of a meeting of security holders, who then must approve the arrangement. After shareholder approval is obtained, if all the conditions of the interim order are met, the court proceeds to give its final order and approve the plan of arrangement.

In the case of an amalgamation (merger) transaction, an amalgamation agreement is prepared and presented to the shareholders for approval. Subject to meeting requisite shareholder approval and provincial corporate and securities laws requirements, the amalgamation is completed on filing the articles of amalgamation with the corporate registry in the provincial or federal jurisdiction in which the target company is principally regulated. Note also that an amalgamation can be a part of a plan of arrangement.

## Banking

### *Lending*

The main banking document is the senior credit agreement under which the senior debt facilities (typically amortizing and non-amortizing term loans with working capital lines and in some instances, capital expenditure or acquisition facilities) are documented. If there is subordinated or mezzanine debt, there is typically a separate credit agreement under which that debt is made available, and an intercreditor or subordination agreement recording the respective rights of the senior and subordinated/mezzanine lenders.

### *Security*

Senior lenders usually request that the target company enter into a general security agreement securing the obligations under the senior facility against the assets of the target company. Lenders may also request a pledge of shares from the Canadian acquisition entity over the shares of the target company as further collateral security in which case the parties enter into a share pledge agreement.

## 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

### Private context

In a private company buyout context, buyer protections usually take the form of negotiated warranty and indemnity coverage from the seller (being either the shareholder(s) in a share sale or the company from which the business and assets are being acquired). The terms of that coverage vary from transaction to transaction. It is quite normal however to expect that limits will be placed in relation to any coverage of this type, including claim thresholds, deductibles and caps, time limits and adjustments for items otherwise disclosed or accounted for. Buyers may also negotiate a holdback or escrow of a portion of the closing proceeds for a period following closing as security against a breach of representations and warranties. Representation & warranty insurance products are available in Canada, though this is in its infancy.

## Public context

In a public share buyout context, the level of buyer protection which can be obtained is less than in a private context. In the context of a buyout of certain assets or a division of a publicly traded entity, a buyer receives similar protection as in a private company asset transaction. The primary form of protection usually takes the form of conditions precedent to the acquisition (that either need to be satisfied or not triggered).

### 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

Conflicts of interests in the context of Canadian corporate buyouts involve the statutory and fiduciary obligations placed on directors set out in the applicable corporations law and at common law or, in Quebec, civil law. This includes a duty on directors to exclude themselves from voting in relation to transactions in which they have a conflict and to not otherwise misuse their positions to benefit themselves.

In addition, provincial securities laws set out specific rules governing related party transactions involving public companies, the goal of which is to ensure transparency and full disclosure in the event of a conflict of interest involving an acquisition of a public company.

Furthermore, the board of the target company typically requires a valuation from an arm's length third party business valuer to be prepared for the board prior to approving any particular transaction, indicating that the transaction is fair to the shareholders of the company from a value perspective.

### 10. How are the equity arrangements typically regulated in a buyout?

The equity arrangements in a typical private buyout are regulated primarily by a shareholders agreement. Additionally, the relevant company's constituent documents (i.e., its articles of incorporation/by laws) would include specific provisions relating to share rights and privileges attaching to the relevant classes of security to be issued.

### 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

Canadian corporate statutes permit a large degree of tailoring and customization in terms of designing a corporation's capital structure and the rights and privileges attaching to the shares of various classes. The company's constituent documents can create an unlimited number of classes of shares and these classes may differ dramatically in relation to voting rights, entitlement to dividends, priority on winding up, conversion rights, and redemption and repurchase rights.

The corporate statutes in Canada do however require that at least one class of shares has the right to vote at all shareholders' meetings and the right to receive the remaining property of the corporation on dissolution. In the event that the corporation has only one class, these rights are automatically vested in the shares of that class.

### 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

A corporation may be formed under the laws of any province or territory or under the federal law. If formed under the Canada Business Corporations Act (CBCA), it is empowered to carry on business throughout Canada, although still subject to provincial laws of general application, including the requirement to register or obtain an extra provincial license.



## Board constituency

Private corporations may have one or more directors. They may provide in their articles for a minimum and maximum number of directors, with the precise number to be determined by the shareholders (or if so empowered, by the directors).

Corporations governed by the CBCA must have a board of directors composed of at least 25% resident Canadians, and if there are fewer than four directors, at least one must be a resident Canadian. The corporate statutes in each of the provinces and territories of the Yukon, Prince Edward Island, Nunavut, British Columbia, Quebec, Nova Scotia, and New Brunswick do not require a percentage of a corporation's directors to be resident Canadians. Canada's federal corporate statute and the provincial corporate statutes of Quebec, Ontario, Alberta, Manitoba, Saskatchewan, Newfoundland and Labrador require that a certain percentage of a corporation's directors be resident Canadians. In addition, a director must not be an undischarged bankrupt, under the age of eighteen years or of unsound mind.

For public corporations, a board must have a minimum of three directors of which, at least one-third must not be employees or officers of the corporation or any of its affiliates. Additionally, Canadian securities exchanges have certain board of directors' independence requirements that must be adhered to by listed companies.

Directors of listed companies are also required to submit an in-depth personal information form or 'PIF' prior to qualifying to act as a director of a public company under the rules of the Canada's principal securities exchanges.

## Appointment and removal of directors

Normally, any director can be removed by an ordinary (majority) resolution of the shareholders at an annual or special meeting of shareholders.

## Differential voting rights

Differential voting rights for directors are not permitted in Canada. Each directors is entitled to one vote at a meeting of directors unless otherwise disqualified by reason of conflict of interest or the terms of a unanimous shareholders agreement.

### 13. What measures are commonly used to give a fund some level of control over key operating and financial decisions made by a portfolio company?

In the private company context, control over key operating and financial decisions is generally obtained via a shareholders agreement. A shareholders agreement may contain rights to appoint one or more directors on the board of directors of the portfolio company, certain rights to receive financial and operating information on a regular basis as well as certain veto rights in relation to particular financial decisions.

In addition, a shareholders agreement typically provides and governs the transfer and other liquidity rights available to the shareholder.

### 14. What employment terms are generally imposed on management in a buyout?

It is common for senior members of a management team in a buyout scenario to enter into an executive services agreement. It is common for remuneration under an executive services agreement to include a fixed component and a bonus component referable to performance. Equity incentives may be covered in these agreements.

Key personnel are likely to be asked to enter into non-competition and non-disclosure agreements as well. Non-competition and non-disclosure agreements are generally interpreted in favor of the employee in Canada and as such expert advice must be obtained to ensure that these agreements will be enforceable by Canadian courts.

## 15. What incentives can be offered to management and how are they typically structured?

There is a great deal of flexibility concerning incentives offered to management, although in the case of public companies additional considerations apply.

### Options

These incentives generally take the form of ordinary equity or options to acquire equity. It is also possible to create forms of phantom equity, but careful planning for accounting, tax and securities issues in relation to phantom equity plans is required.

### Ratchet mechanisms

It is not uncommon for management to be offered a 'ratchet' in relation to their equity which operates to give them a greater overall return if the investment for the private equity fund outperforms certain base return thresholds (usually measured by reference to the fund's internal rate of return on the investment or an absolute money multiple (i.e., an absolute dollar benchmark against which performance is to be judged)). Generally these ratchets will only crystallize once the fund has achieved a full exit on its investment.

### Management equity plans

In certain cases, management equity plans are adopted to regulate the way in which management equity is issued (which can include earning or vesting of the equity over a period subject to achievement of agreed financial hurdles) and can be reacquired by the portfolio company if a manager ceases to be employed for any reason.

### Good leaver and bad leaver provisions

While good and bad leaver provisions are not unheard of in Canadian equity plans, they are not common or standard and are more often found in shareholder agreements than in incentive plans. Typically they are seen in plans put in place by foreign companies that establish or take over operations in Canada and the provisions are consistent with what that company implements in other countries.

An example of use in a Canadian plan would be in connection with restricted shares that are issued to the manager at grant and are intended to be non-forfeitable at the time of grant or only forfeitable as to all or a part of the shares if the manager is a 'bad leaver'. Consistent with other jurisdictions, the definition of 'good leaver' in incentive plans includes a manager:

- (a) who dies;
- (b) who becomes incapacitated through physical or mental illness;
- (c) whose employment is made redundant; or
- (d) who voluntarily retires from employment after a pre-agreed period of time.



A 'bad leaver' can either be a person leaving under any other circumstance or a person in a similarly defined list, such as:

- (a) a person leaving voluntarily (other than retiring) to work elsewhere before expiry of a pre-agreed upon period of time;
- (b) dismissal for cause; or
- (c) dismissal which is not constructive or unfair.

Care must be taken so not to create ambiguity for leavers and ensure that leavers fall clearly into either the good leaver or bad leaver category.

## 16. How are buyouts typically debt financed and secured?

While it varies from transaction to transaction, typically the largest portion of the cost of an acquisition is provided from debt provided by banks and other financial institutions. The amount of debt that can be raised is typically calculated as a multiple of the earnings of the target business. Canada has a number of domestic and international banks and financial institutions willing to participate in leveraged deals.

Security is typically by way of security interests and charges over all of the assets of the transaction special purpose vehicles and the target companies. These companies may also cross-guarantee their obligations to the bank lenders.

## 17. Are there financial assistance issues to consider when undertaking a buyout?

The provisions under Canadian law restricting financial assistance were repealed by the CBCA and the Ontario Business Corporations Act (**OBCA**). These provisions were repealed when various amendments to the CBCA and OBCA were made in 2001 and 2006, respectively. Previously, the restrictions were found in Section 44 of the CBCA and Section 20 of the OBCA.

In the absence of the provisions restricting financial assistance under the CBCA and OBCA, there are no restrictions that would prohibit a corporation from giving financial assistance by means of a loan, guarantee or otherwise:

- (a) to any shareholder, director, officer or employee of the corporation or of an affiliated corporation; or
- (b) to any associate of a shareholder, director, officer or employee of the corporation or of an affiliated corporation.

This applies whether or not:

- (a) the corporation is, or after giving the financial assistance would be, unable to pay its liabilities as they become due; or
- (b) the realizable value of the corporation's assets, excluding the amount of any financial assistance in the form of a loan or in the form of assets pledged or encumbered to secure a guarantee, after giving the financial assistance, would be less than the aggregate of the corporation's liabilities and stated capital of all classes.

Despite the repeal of the provisions restricting financial assistance, directors involved in transactions involving the giving of financial assistance are subject to statutory fiduciary duties to act in the best interests of the corporation and can be sued for failing to do so. It is arguable that this provides adequate safeguards.

## 18. What are the implications under the corporate benefit laws of Canada for a company providing financial assistance?

Even though there are no explicit restrictions that would prohibit a corporation from giving financial assistance (as noted in the answer to question 17) the directors of the relevant corporation need to act in the best interests of the company. The effect of this is that financial assistance cannot be given unless it is in the best interests of the company.

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

Generally priority is determined by a first-in-time registration system for both personal and real property. However, these priorities can be overcome by:

- (a) special priority provisions for registrants; or
- (b) those taking possession and control of certain types of property.

### Personal property security

In Canada, the power over the creation, perfection and priority of security interests in personal property primarily rests with the individual provinces. There are two basic regimes in Canada under which the provinces maintain and regulate the protection of security interests in personal property.

All of Canada's provinces and territories (other than Québec) have enacted a specific personal property security act (**PPSA**). Generally, the PPSA in each province is similar in terms of form and substance. Each PPSA uses a registration system that provides notice of security interests to people who deal with a debtor and his, her or its property. With specific exceptions, priority is determined by the order of registration.

### Québec personal property security

The Province of Québec, a civil law jurisdiction, permits security to be taken under the *Civil Code of Québec (CCQ)*. The CCQ requires security to be taken over movable, or personal property by way of hypothec. The CCQ also regulates the granting of charges over immovables or real property. The CCQ requires all hypothecs to be published, or registered for the secured party's interests to be effective as against third parties.

### Bankruptcy

Bankruptcy and insolvency legislation is a federal matter that recognizes the rights of secured creditors under provincial laws but may alter unsecured creditors' priorities from the status that they have prior to bankruptcy. In addition, bankruptcy legislation sets out provisions regarding preferential transactions and the ability of a trustee in bankruptcy to reverse those transactions.

### Security under the Bank Act

Canadian chartered banks have a special form of security that they can take under the *Bank Act (Canada) (Bank Act)*. Canadian banks may only take Bank Act security from specific classes of borrowers, such as wholesale and retail purchasers or shippers of, and dealers in, farm, mine and sea products, and manufacturers.

Bank Act security is available to charge a borrower's inventory and certain other property such as receivables generated from the sale of its products. One of the advantages that Bank Act security offers is the ease with which the security can be taken and perfected across the entire country without the need for the bank to register its interest in each jurisdiction.



## The Bulk Sales Acts

Ontario is the only remaining Canadian province where bulk sales legislation is in force.

The *Bulk Sales Act* is intended to prevent a business debtor from selling its stock in bulk without taking the claims of its unsecured creditors into account. Its application can be triggered by transactions that involve the sale of much less than all of a business. Its implications should be considered whenever assets or a division of a business sold in Ontario form part of an asset purchase.

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

### Overall tax treatment of structure

A key consideration is whether or not more than 50% of the value of the underlying investment consists of Canadian real estate, resource or timber properties known as ‘taxable Canadian property’ (TCP). This is important because dispositions of TCP (including an indirect disposition that arises when an interest in a holding entity is sold) are generally taxable in Canada and subject to special withholding and filing requirements. The TCP rules have a 60-month look back so that the TCP rules generally apply if the investment was TCP at any time in the 60 months before the sale.

If an investment is TCP, then it can impact the investor’s after-tax return. A potential investor ought to determine whether the Canadian tax arising on the future sale of a TCP investment can be claimed as a foreign tax credit in the investor’s home jurisdiction.

If the shares constitute TCP and the shares are being purchased from a non-resident of Canada, the buyer may have to withhold 25% of the purchase price (unless it obtains a certificate of compliance from the Minister of National Revenue).

Whether or not the investment is TCP, a key issue is determining whether or not the holding entity is fiscally transparent (also known as ‘flow-through’) for Canadian tax purposes. Corporations are never fiscally transparent for Canadian domestic tax purposes and can lead to double tax. Limited partnerships are widely used to provide flow through treatment and avoid double tax.

A non-resident investor ought to be careful when considering the interaction of the tax treatment of the structure in Canada and the tax treatment of the structure in the investor’s home jurisdiction.

If a corporation must be used, some Canadian corporations (ULC’s) can be fiscally transparent under U.S. or other foreign tax regimes, which can provide benefits in that other jurisdiction (but not in Canada).

### Stamp duty/transfer taxes

Unlike many other jurisdictions, Canada does not have a stamp duties regime.

### Thin capitalization rules

A potential investor should also consider the capital structure of the investment and in particular the debt/equity mix. It may be possible to ‘push’ acquisition debt into the Canadian operating vehicle/portfolio company to reduce Canadian income tax on operating profits, but there are a number of technical requirements that must be satisfied. For example, a maximum 1:5:1 debt to equity ratio can apply to investor debt under the Canadian ‘thin cap’ rules. Bona fide interest paid to arms length parties is generally not subject to the thin capitalization rules and can be exempt from Canadian withholding tax.

## Withholding tax

Canadian withholding tax applies to a variety of payments made to non-residents of Canada, including certain rents, royalties, management fees and non-arm's length interest. In some cases, withholding tax may be reduced or eliminated pursuant to a tax treaty to which Canada is a party. If Canadian withholding tax applies, the statutory tax rate is 25% of the gross amount of the payment (subject to reduction under any applicable tax treaty).

There is also a provisional withholding of 15% of the gross amount of payments made to a non-resident of Canada for services performed in Canada. This is not a permanent tax and is potentially refundable if the actual Canadian tax liability of the non-resident is less than the withheld amount.

Canada also has a broad tax treaty network and potential benefits (such as reduced withholding rates) under tax treaties ought to be considered.

## Tax consequences on an exit

A selling shareholder is generally liable to pay tax on the sale of shares or assets. The amount of tax is generally based on the difference (i.e., the 'gain') between the sale proceeds (or fair market value for dispositions to related parties) and the seller's cost basis in the relevant share or asset (generally, the cost to the taxpayer of the property). The gain is generally taxed as a capital gain; i.e., one-half of the gain is included in the seller's income and taxed at the seller's combined (i.e., federal and provincial) marginal income tax rates.

## 21. What forms of exit are available?

In Canada, the most common forms of exit for investments in private companies are an IPO or third party trade sale of the business (assets or shares). Dual track exits are common in Canada.

It is also not uncommon for private equity funds to achieve a return on their investment during the life of the investment by undertaking a leveraged recapitalization. In that case, the return can take the form of a dividend and/or some other form of capital distribution or buy back depending on the capital structure of the entity and the provisions incorporated into the articles of association/bylaws of the target entity for those purposes at the outset.



## Chile

### 1. What structures do private equity funds typically use to manage their funds?

#### Foreign private equity funds

In most cases, a foreign private equity fund planning to invest in Chile will not organize an investment fund locally. Foreign investment funds tend to incorporate a Chilean holding company as the investment vehicle, as follows:

- (a) *sociedad de responsabilidad limitada* (**SRL**);
- (b) Corporation (*sociedad anónima*) (**SA**); and
- (c) Stock Company (*sociedad por acciones*) (**SpA**).

The legal system is relatively neutral in relation to which one of these corporate entities could be chosen (with the main differentiators relating to tax and corporate governance matters). For example, an SRL has an advantage over an SA in terms of rules for tax-deferred reinvestment of profits in Chile (however, this mechanism will be phased out starting 1 January 2017). A SpA is treated as an SA for tax purposes, but is much more flexible than an SA in terms of corporate governance and preferences, conversion of securities and profits distribution, among other differences.

#### Chilean private equity funds

Local investment funds are generally only formed by local investors investing in Chile, or in the event that a foreign private equity fund intends to raise funds in Chile, either as a:

- (a) private investment fund (**FIP**); or
- (b) public or registered investment fund (**Registered Fund**),

together, **Investment Funds**.

An Investment Fund is not a legal entity, but only a ‘patrimony’ (i.e., a pool of assets and liabilities) that is segregated and independent from the patrimony (assets and liabilities) of the corporation that manages the fund. Therefore, the management company is required to maintain segregated accounts for each investment fund under its management.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in Chile?

#### Foreign funds

Foreign funds do not require any type of special authorization to invest in Chile or to raise funds in Chile as long as they do not make public offerings of unregistered securities.

#### FIPs

A Chilean fund organized as a FIP does not need any special authorization, *per se*, although a FIP’s manager is required to be registered with, and is subject to the reporting requirements of, the SVS. FIPs can be managed by the authorized manager of a Registered Fund (see below) or by any corporation (however, a FIP may not use the term ‘fund manager’ in its name unless it is managed by an authorized manager of a Registered Fund).

FIPs are not authorized to make a public offering of unregistered securities, such as its quotas or participations in the fund. These registration and reporting requirements are different from the regulations applicable to Registered Funds' managers, which are regulated entities (described below).

## Registered funds

Registered Funds have special rules for their organization, and must be organized and managed by a special purpose corporation that requires the prior approval of the Chilean corporate regulator, the Superintendency of Securities and Insurance (**SVS**).

Registered Funds must be authorized and registered with the SVS, and must be managed by a fund manager company (also a regulated entity). They are authorized to make public offerings of their issued securities such as the quotas or participations in the funds.

### 3. Are there any approvals required for investments by foreigners in Chile and, if so, what is the process?

Chilean laws are structured to encourage foreign investment by providing a stable and certain regulatory framework to allow foreign investors to compete on equal terms with local investors.

#### Foreign investment approvals and notifications

As a general rule, Chilean law does not require investors to obtain any foreign investment permits or licenses, other than for specific industry sectors (e.g., insurance, banking and telecommunications). There are almost no approvals required for investments by foreigners, although registration of the investments with the Central Bank of Chile (**Central Bank**) is mandatory.

Although not mandatory and provided that certain requirements are met, foreign investment can, however, be registered under the Foreign Investment Statute (Decree Law No. 600/1974) (**FIS**), which affords foreign investors with some benefits (described below). Under the FIS, foreign investment can be made in foreign currency, tangible assets (e.g., goods or equipment), intangible assets (e.g., technology) and capitalized profits. For investments in foreign currency, the minimum amount to qualify for registration under the FIS is USD 5 million. This minimum does not apply to investments made in physical assets and technology, where a minimum of USD 2.5 million applies. Normally, approval of foreign investment is granted within 25 days, however, authorization for the immediate liquidation of capital may be granted at the moment of the filing of a foreign investment application.

The investor will execute a simple contract with the Chilean government setting out their rights and obligations upon approval. The contract will include terms providing for the time within which capital must be brought into the country, the form of the capital contribution, guarantees that the foreign investor will not be subject to discriminatory conduct and will have access to the Formal Exchange Market to purchase foreign currency and to repatriate the capital and any profit arising from the investment. The contract may also fix the rate of certain direct and indirect taxes applicable to the investment.

Following a recent tax reform late in 2014, the FIS is due to be repealed as of 1 January 2016, and accordingly only those applications filed on or before 31 December 2015 will be considered for approval. Foreign investment contracts already executed with the State of Chile will remain in force.

#### *Foreign Exchange Regulations (Chapter XIV)*

If an investment application under the FIS is not approved (which is unusual), or in other cases (e.g., required information being unavailable to secure clearance by the Foreign Investment Committee), the investment can nevertheless be effected under Chapter XIV of the Foreign Exchange Regulations, which is administered by the Central Bank (Regulations). Investments under the Foreign



Exchange Regulations may only consist in foreign currency. The minimum investment is USD 10,000.

Even when approval is granted under the FIS, investors must also report foreign investment transactions to the Central Bank and perform them in the formal currency market, in accordance with the Foreign Exchange Regulations.

Neither the FIS nor the Regulations impose any domestic ownership requirements (i.e., 100% foreign ownership is possible). In addition, there is no maximum period of time for foreign investments to remain in Chile if registered only under the Foreign Exchange Regulations.

### Exchange controls

The Central Bank Act (**CBA**) sets out certain types of international exchange operations that may be limited or restricted by the Central Bank. At present, only three types of restrictions mentioned in the CBA have been implemented by the Central Bank, but there is always the possibility that the Central Bank will decide to also apply some of the other restrictions. The current principle, therefore, is total freedom for foreign exchange transactions (i.e., complete freedom to acquire and make payments abroad using foreign currency, from Chile and vice versa). Entities and individuals are free to purchase, sell, keep, remit abroad, and bring into Chile foreign currency (with a few reporting duties which may apply).

Broadly, the three types of restrictions/limitations referred to above are:

- (a) foreign exchange transactions which must be conducted through the Formal Exchange Market (e.g., a commercial bank) and reported to the Central Bank (e.g., foreign exchange transactions performed by insurance and reinsurance companies formed in Chile, investments, deposits and loans made abroad by Chilean resident individuals in excess of USD 10,000, or capital contributions, investments, deposits and loans made from abroad and into Chile in excess of USD 10,000);
- (b) foreign exchange transactions which must be conducted through the Formal Exchange Market, but not reported to the Central Bank (e.g., license and royalty payments abroad regardless of the sums involved; and
- (c) other foreign exchange transactions which must be reported to the Central Bank (e.g., payments relating to imports and exports).

## 4. Who are the relevant regulators in Chile and how much interaction would one generally expect when undertaking a buyout?

The primary regulatory authorities in Chile in a corporate context are:

- (a) the Superintendency of Securities and Insurance (**SVS**) - the primary regulator of corporate and financial services, including the offering of securities and stock exchanges;
- (b) the Central Bank of Chile (**Central Bank**) - in charge of foreign investment registration;
- (c) the Foreign Investment Committee - the governmental agency dealing with foreign investment;
- (d) the Free Competition Court and Economic National Prosecutor – the competition/ antitrust regulator and enforcement agency, respectively; and
- (e) the SII (*Servicio de Impuestos Internos*) – the Chilean taxation authority.

The level of involvement of the SVS in a buyout depends on whether the transaction is undertaken in relation to a private or publicly listed company. The interaction is generally higher for public

companies as the public takeovers rules (**OPA**) may apply. If the target company is not listed, the direct involvement may be very limited or nil. Interaction with other authorities depends on the nature of the transaction.

## 5. How are buyouts typically undertaken in the private and the public markets?

### Private markets

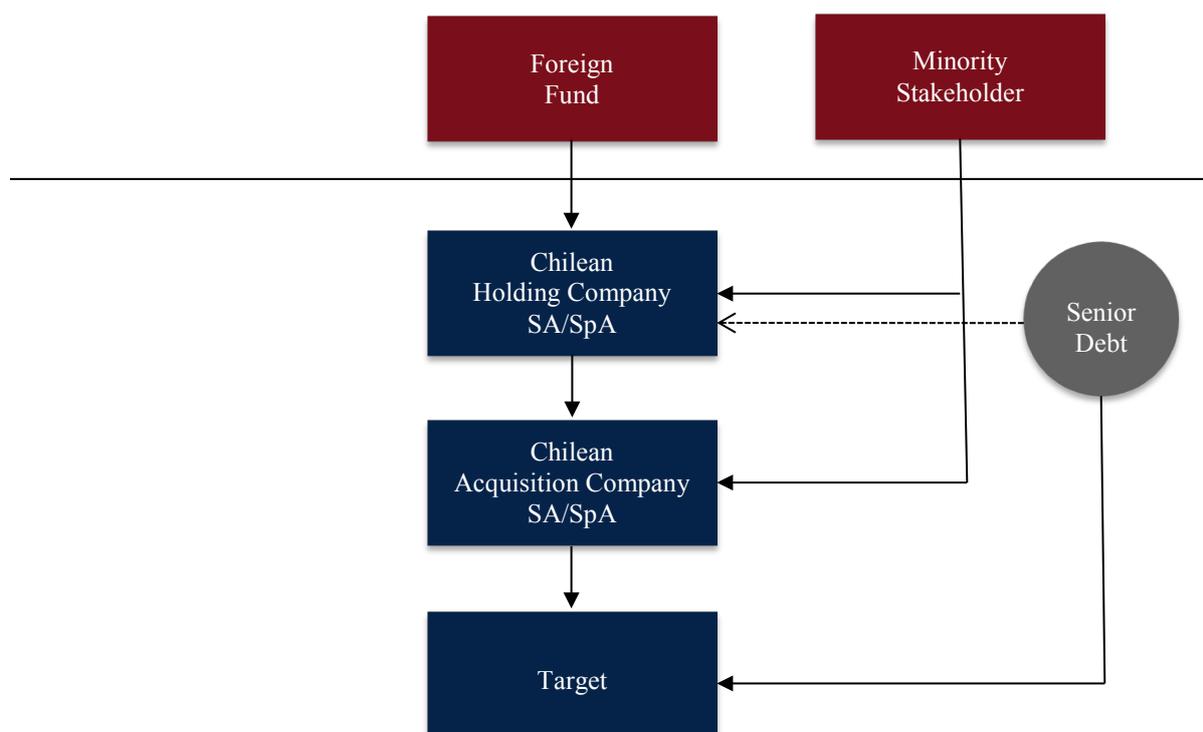
In a private context, transactions are usually undertaken by way of a negotiated acquisition. That is, negotiated sale and purchase documents are prepared, negotiated and executed and those documents record the terms of the sale and acquisition and the rights and liabilities of the parties. Transaction documents in these cases are normally based on U.S. forms and are often prepared in English if one of the parties is a foreign entity. Typical terms include representations and warranties, purchase price adjustments, anti-dilution provisions, covenants, events of default, indemnities and confidentiality and non-compete clauses. Dispute resolution is usually stated to be by arbitration.

### Public markets

In the public context (i.e., an acquisition of a listed company) most buyouts are concluded under the rules of mandatory public takeovers governed under the Securities Market Act. The offeror is required to make public announcements informing the market of the launch of the tender offer and must make available to all interested parties a prospectus containing all terms and conditions of the tender offer.

## 6. What is the typical corporate structure used when doing a buyout?

One common structure used by foreign investors such as private equity funds is the following:



Although acquisition structures do vary from transaction to transaction, it is fairly common to see a two-level holding company such as the SA/SpA structure shown in the diagram. This structure allows the organization to differentiate between the flow of funds from the senior lenders for acquisition purposes (going to the holding company) and for funding the target company.



## SA

An SA may either be public/open or private/closed. An SA is public if its shares are registered (either voluntarily or as mandated by law) with the SVS. An SA is required to register its shares if it has at least 500 shareholders or more than 10% of its issued capital is held by more than 100 shareholders. Shareholders who hold more than 10% of the share capital are excluded for the purpose of this final calculation.

All other SAs are private, with the exception of insurance and reinsurance companies, pension fund administrators and other regulated entities, which are known as ‘special’ SAs and which, even if private/closed in their own structure, are subject to the same rules applicable to public/open SAs.

## SpA

The SpA is a newly created legal entity which is a hybrid vehicle that has the basic structure of an SA but some of the flexibility of an SRL. In particular, SpAs have fewer restrictions than SAs in connection with restrictions to protect minority interests which makes them especially useful for venture capital or seed capital enterprises. As they have been recently created, there is still limited relevant case law or practical experience in connection with SpAs, but generally they receive the same tax treatment as SAs and, like SAs, the liability of shareholders is limited. Accordingly, company losses may not be set off against shareholder’s other income.

SpAs are the only type of legal entity in Chile where 100% direct ownership can be achieved because they do not need to have a minimum of two shareholders to exist. Foreign individuals or foreign entities may be shareholders of a Chilean SpA. Importantly, the formation documents may restrict the transfer of shares and may establish the minimum or maximum amount or percentage ownership that a single shareholder may have, either directly or indirectly through one or more affiliates or other related parties. Likewise, the formation documents may include mandatory put or call option rights in favor of another shareholder, the company or even a third party, if certain conditions are met. For these purposes any buyer of shares in an SpA is required to expressly state in the purchase agreement that it accepts the bylaws of the company at the time of the transfer.

## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

#### *Private companies*

For a buyout negotiated in a private context, the primary legal document that records the transaction is a stock purchase agreement. There are generally other ancillary documents depending on the nature of the deal. These can include employment/non -compete agreements with management and a shareholders agreement.

#### *Public companies*

For a buyout in a public context the documentation prepared depends on whether the transaction triggers the need for a mandatory tender offer. In a public takeover the primary document for the offeror is the prospectus.

### Banking

The main banking documents are the senior facilities agreement and the corresponding promissory notes. For enforceability purposes, it is customary in Chile to document the debt twice – once in a facilities agreement and, again, in promissory notes. If default under the facilities agreement is due to a failure to pay, the promissory notes can be enforced more easily than the facilities agreement.

Pledges and security interests can generally be held by the senior lender or by a security agent. A fairly recent legal development is the creation of the security agent. The security agent can hold security on behalf of one or more creditors.

## 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

In a private context, buyer protections usually take the form of negotiated warranties and indemnities from the seller, the terms of which vary considerably from transaction to transaction. It is typical, however, to expect that limits be placed in relation to any coverage, including thresholds, baskets, caps, time limits and adjustments for items otherwise discounted or accounted for. Finally, it is quite common to see escrow arrangements or hold-backs for a limited period of time. Warranty & Indemnity insurance is extremely rare in Chile.

In the case of a public M&A deal, the above-mentioned protections can only be obtained from the majority or controlling shareholders with whom the purchaser may enter into an agreement in advance to launch a tender offer. The terms of the agreement must comply with several terms and conditions established under Chilean securities law. Chilean securities law does not allow the purchaser to obtain most of the above-mentioned protections, price adjustments or indemnities from minority selling shareholders.

## 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

There are currently no specific laws regulating how conflicts are managed in a buyout. The Chilean Corporations Act (**Corporations Act**) does, however, impose certain general statutory obligations on directors and officers as follows:

- (a) directors are liable to the company and the shareholders for any willful misconduct or negligence damaging the company or the shareholders; and
- (b) directors cannot act against the interests of the corporation, nor can they obtain unfair benefits.

Additionally, general fiduciary obligations dictate that directors and officers should not place themselves in a position of conflict.

Common practice in Chile generally sees members of the management team who participate in the buyout quarantined from the decision concerning the buyout.

There is also a set of provisions in relation to ‘material transactions’ with related parties. In the case of private SAs, material transactions with related parties must be carried out on market terms. The directors involved must also abstain from voting in relation to the relevant board resolutions, or otherwise the relevant board resolutions must be approved by two-thirds of the shareholders.

Much stricter procedures apply to public SAs, including the requirement to obtain independent evaluations and reports, disclosure and publication of information, abstention by the directors involved and approval, in some cases, by two-thirds of the shareholders.

## 10. How are the equity arrangements typically regulated in a buyout?

The equity arrangements in a typical buyout are regulated primarily by a shareholders agreement. In certain cases, some of these arrangements are also regulated in the bylaws of an SpA or SA, as the case may be (e.g., the rights attached to a class of shares).



## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

SAs are relatively inflexible in terms of the rights that different classes of stock may have. For example, any preferred stock must be limited in time. Also, the Corporations Act prohibits preferences consisting of the right to be paid dividends other than from the profits of the previous fiscal years.

SpAs have a great deal of flexibility in relation to the types of equity that can be issued and the level of rights tailoring that can occur.

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

Private SAs must have at least three directors, all of whom must be natural persons (although none of them needs to be a Chilean national or a Chilean resident). Public or listed companies must have at least five directors, also with no residency requirements.

Differential voting rights are not permitted for either private or public SAs. SpAs, however, have much more flexibility in relation to board constituency and voting rights. In fact, it is not mandatory that SpAs are managed by a board, leaving the shareholders free to decide if the entity will be managed by one or more individuals acting individually or jointly, or by a board, and the number of board members, etc.

It is common for the shareholders agreement of all types of companies to provide specific removal rights in relation to directors. The only special rule is that the board must be completely reconstituted if one of the directors has to be replaced (except in the case of inability or voluntary resignation). In practice, this constraint does not create any real impediment to board structuring.

## 13. What measures are commonly used to give a fund some level of control over key operating and financial decisions made by a portfolio company?

Control over key operating and financial decisions may be enshrined in the shareholders agreement. Control may be secured by the private equity fund having, under the shareholders agreement:

- (a) the right to appoint one or more directors to the board of the portfolio company;
- (b) the right to appoint the chairman with a casting vote, in case of deadlocks at board level;
- (c) the right to receive financial and operating information on a regular basis; and
- (d) specific consents or veto rights over particular decisions of the portfolio company, including decisions that relate to financial matters, capital variations, etc.

## 14. What employment terms are generally imposed on management in a buyout?

It is common for senior members of a management team in a buyout to enter into formal employment agreements. Those agreements provide for an initial employment period, severance payments (equal to or over the statutory minimum requirements) and incentives. It is also common for remuneration under these agreements to include a fixed component and a bonus component based on performance. Equity incentives vary from transaction to transaction.

## 15. What equity incentives can be offered to management and how are they typically structured?

There is a great deal of flexibility concerning incentives that can be offered to management. These can take the form of ordinary equity or options. Phantom equity is rather uncommon, but it is possible.

Good leaver and bad leaver provisions are also common in the shareholders agreement and in the employment agreements, effectively giving the portfolio company (an SA or a SpA) or the other shareholders the right to acquire the equity at a pre-determined price in a leaver situation. SAs may only acquire their issued shares in certain specific cases, after a special procedure that includes approval by two-thirds of the shareholders and time limits. SpAs, however, may set out different rules in this regard.

## 16. How are buyouts typically debt financed and secured?

The financing of buyouts varies considerably from transaction to transaction. As the cost of capital abroad is usually considerably lower than in Chile, it is not uncommon to see the foreign holding company (e.g., a foreign private equity fund) pay 100% of the costs of an acquisition without having any local financing. This type of ‘parent financing’ is normally structured in part with equity and in part with debt. Chilean rules on thin capitalization may in certain circumstances limit this type of financing to a 3:1 debt to equity ratio or apply costly tax implications to thinly capitalized entity structures.

It is also common to see a local acquisition with foreign financing, or alternatively with local financing secured by a foreign financial house, which, in turn, receives a deposit from the company acquiring the portfolio company. This type of financing is commonly treated as related-party financing for thin capitalization purposes, and therefore should be carefully structured and monitored on a yearly basis, to comply with the (usually maximum) 3:1 debt-to-equity ratio.

## 17. Are there financial assistance issues to consider when undertaking a buyout?

In Chile, the concept of financial assistance has not been developed yet and the giving of financial assistance is generally permitted. For instance, Chilean laws do not contain any financial assistance rules restricting the granting of security. A company incorporated in Chile may grant any security as long as the corresponding corporate authorizations and powers of attorney have been duly granted.

Nevertheless, we believe that some provisions of the Corporations Act would implicitly regulate financial assistance. For example, Article 42, No. 1 of the Corporations Act expressly prohibits directors of Chilean corporations from proposing amendments to their bylaws, approving the issue of securities, adopting policies or making decisions that are not in the corporation’s interest (but are in the interests of related third parties).

## 18. What are the implications under the corporate benefit laws of Chile for a company providing financial assistance?

Generally speaking, since the concept of financial assistance has not been developed yet, there are no direct implications under Chilean law for a company providing financial assistance.

Nevertheless, as the concept of financial assistance is arguably implicitly regulated under the current general rules of Chilean corporate law, there may be some implications for corporations giving financial assistance. As mentioned in the answer to question 17, directors of Chilean corporations are prevented from making any decisions that are not in the corporation’s interests (e.g., the issue of securities). In the event of a breach, a director is personally liable (i.e., with their personal funds) and jointly and severally liable for the whole amount of any damage caused by the breach.



Further, under Article 45 of the Corporations Act, directors are presumed to be responsible and bear the burden of proof if:

- (a) the share issue or financial assistance is against the corporation's interests; and
- (b) the directors receive a benefit in an improper manner from that financial assistance (whether directly or through another individual or legal entity).

Further, the granting of a personal guarantee or a real guarantee (which requires delivery of the pledged guarantee to the creditor) to secure third party obligations for an amount exceeding 50% of a Chilean corporation's assets must be approved by two-thirds of the corporation's shareholders attending a special shareholders' meeting. If however a guarantee is granted to secure the obligations of a subsidiary or affiliate company, the approval of the board of directors is sufficient.

In either case, dissenting shareholders have the right to withdraw from the company and the company must pay those shareholders the value of their shares (i.e., book value in the case of private SAs and market value of the shares in the case of public SAs, determined in the manner specified in the Corporations Act).

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

As in most jurisdictions, the Bankruptcy Act acknowledges different categories of creditors. Secured creditors have payment preferences over unsecured creditors and, in certain cases, even over other secured creditors. Further, the Chilean Civil Code sets out first, second, third and fourth classes of preferences. Some preferences are general (the preference applies over the whole estate of the bankrupt, e.g., taxes, certain labor rights, etc.) and other preferences are specific (the preference only applies over certain assets of the debtor, e.g., mortgages and pledges).

The bankruptcy proceedings affect all of the existing and attachable assets of the debtor at the time of the bankruptcy declaration.

By law, the order of priority in distribution is as set out below.

### First priority claims

First priority claims are:

- (a) bankruptcy trial costs;
- (b) bankruptcy administration costs;
- (c) employee remuneration;
- (d) social security payments relating to employees of the debtor;
- (e) monies needed for the subsistence of the debtor and his or her family; and
- (f) employment severance payments, claims of the State related to any taxes owed e.g., withholding or indirect taxes (such as VAT).

### Second priority claims

Second priority claims are certain possessory liens of an unpaid hostel or hotel owner or an unpaid transport services provider as well as claims of a pledgee over pledged goods.

### Third priority and fourth priority claims

Third class claims are mortgages, and fourth class claims are other special claims that would not normally apply to foreign investors (i.e., claims of the State against collectors and administrators of public goods).

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

### Overall tax treatment of structure

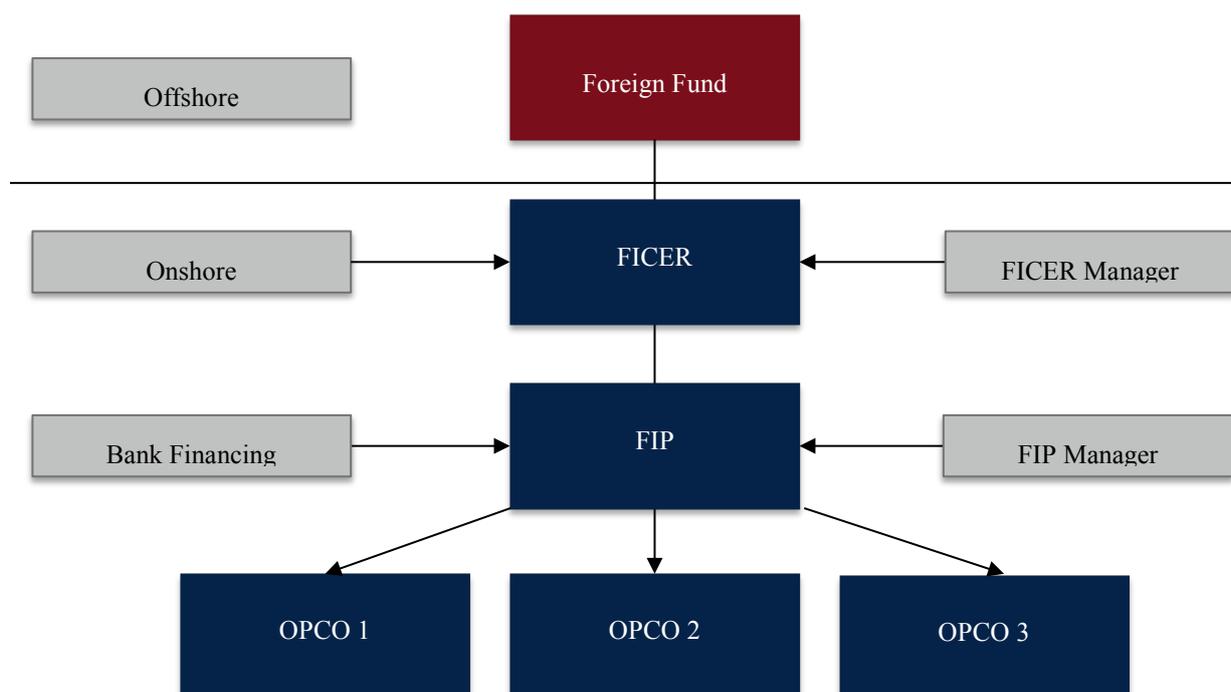
#### Current regime

The tax differences relating to the acquisition vehicle are broadly as follows:

- (a) SRLs have an advantage over SAs in relation to the rules for tax-deferred reinvestment of profits in Chile (note, however, that this mechanism will be phased out from 1 January 2017).
- (b) An SpA is treated as a corporation for tax purposes, but is much more flexible than an SA in relation to matters such as corporate governance and preferences, conversion of securities and profits distribution.
- (c) FIPs and Registered Funds receive pass-through tax treatment because Investment Funds are special purpose vehicles that do not qualify as ‘legal entities’ or ‘legal persons’ (as is the case for SAs and all types of companies generally). FIPs and Registered Funds are segregated patrimonies or funds that are managed by a third party (generally a General Funds Administration Company (**AGF**), or in certain cases, a private corporation or SA).

#### Old FICER/FIP structure

Note that prior to the entry into force of Law No. 20,712 in July 7, 2014, a typical structure was a FICER/FIP structure, as follows:



- (a) Foreign Investment Capital Funds (**FICE**) and Foreign Risk Investment Capital Funds (**FICER**) were taxed at 10% on their profits instead of the general rule of approximately 35%



typically payable by a foreign investor. However, since the enactment of Law 20,712 no new FICEs or FICERs may be incorporated in Chile, although the existing ones may continue operating and therefore may be acquired. Now, as mentioned, foreign entities may invest directly in Registered Funds, in which case the tax treatment is the same that the one that was applicable to FICEs and FICERs.

- (b) FIPs and Registered Funds receive pass-through treatment because Investment Funds are special purpose vehicles that do not qualify as ‘legal entities’ or ‘legal persons’ (as is the case for SAs and all types of companies generally).
- (c) FIPs and Registered Funds are segregated patrimonies or funds that are managed by a third party (generally a General Funds Administration Company or AGF, or in certain cases, a private SA). Given that they are not ‘legal entities’ they are exempt or transparent for the purposes of Chilean corporate tax. However, under the new Investment Funds Law, the quota holders of the investment funds are subject to the following regime:
  - (i) quota holders of Registered Funds that are Chilean residents, are subject to the general tax regime. However, quota holders that are foreign entities are subject to a special single 10% tax that applies to all amounts transferred or remitted abroad in excess of the capital contributions the investors made into the fund;
  - (ii) quota holders of FIPs are subject to general tax regimes applicable to Chilean residents or to foreign residents (withholding tax at a rate of 35% on distributions), as applicable.
- (d) Except for Registered Funds, which have a restriction on a maximum level of indebtedness (1:5 debt to equity ratio), FIPS may legally take debt funding, on an interest-free or interest-bearing basis. However, please note that Chilean funds are most commonly 100% equity funded, so the use of debt funding is unusual among funds in a Chilean business environment.

## Stamp tax

No stamp or registration or any other similar taxes or charges are payable under the laws of Chile in connection with the execution, delivery, performance or enforcement of a share acquisition.

Stamp tax, does, however, apply to promissory notes, drafts and documentation evidencing credit as well as to foreign debt financing (whether documented or undocumented), as part of a leveraged buyout. Promissory notes, drafts, and documentation evidencing credit are subject to a stamp tax calculated on the face value of the document at a rate of 0.033% per month from the execution of the document up until its maturity term (capped at 0.4% of the numerical amount of capital stated in the relevant document). The applicable rate is 0.166% for documents which are in relation to amounts which are immediately payable or do not have a maturity date. For cross-border loans, the tax applies even if there is no credit documentation.

## Income tax

On a share sale, the seller in many cases is subject to a first category tax<sup>6</sup> (the rate of which is 22.5% for 2015) over the capital gain obtained, applied as a sole tax if certain minimum requirements are

---

<sup>6</sup> Chilean Income Tax law is structured to encourage investment and promote savings. For this purpose, it sets out an ‘integrated system’ which consists of two progressive income tax stages, where one is creditable against the other.

First, at the business entity or corporate level a 21% (in 2014) (First Category Tax) yearly tax rate is assessed on the entity’s net taxable income determined in accordance with the Income Tax Law and full accounting records (except for limited cases in which taxation is based on presumed income and accordingly no accounting records are needed to evidence the taxable base). The 21% corporate tax is creditable against the amount due based on second level taxation.

satisfied. Therefore, the capital gain is not subject to the 35% additional withholding tax (applicable in the case of non-residents) or to surtax (applicable in the case of resident individuals) commonly applicable to ordinary business income.

## Goodwill

In many cases, a stock acquisition crystallizes goodwill that the seller is generally not able to amortize for tax purposes. In certain cases of post-acquisition integration, including a situation in which the purchaser acquires 100% of the stock/interest of the target, it is possible to dissolve the target and generate a step-up in basis of the underlying non-monetary assets, increasing tax deductions via additional depreciation or costs of goods sold, up to the assets' fair market value. Any goodwill paid in a stock acquisition over the underlying tangible assets' fair values, will go to an acquisition goodwill account that is non-amortizable for tax purposes. Due to this, in many cases the purchaser will favor an asset acquisition, as in that case it is possible to avoid the crystallization of goodwill and to create a higher tax basis on the tangible assets of the target (therefore obtaining higher charges for the profit and loss statement (from depreciation of fixed assets or cost of inventories sold)).

## VAT

The sale of inventory of a Chilean company will be subject to VAT at a rate of 19%. The sale of fixed assets, including vehicles is subject to VAT at 19%, only if acquired by the seller within four years of the date of the sale (unless the normal tax depreciation period has elapsed before that date). Fixed assets and vehicles must also be detailed in the corresponding Chilean invoices. VAT assessed on sales must be declared and paid by the seller within the first 12 days of the month, following the month of the sale. Taxpayers authorized to electronically issue invoices must declare and pay VAT within the first 20 days of the month, following the month of the sale. Accounts receivable and intangible assets are not subject to VAT.

## Withholding tax

Interest payments arising from debt funding generally attract withholding tax obligations where the lender is a foreign resident, at a rate of 3%, 4%, 15% or 10% depending on the specific debt transaction and other factors such as the lender's country of residence (treaty or non-treaty country, which treaty, etc.). The withholding tax obligations are complied with by the Administration Company or AGF.

## Interest deductibility

Interest expenses arising from debt funding would not be 'tax deductible' from taxable income, because funds are not corporate taxpayers in the first place. But interest payments may potentially be subject to a 'penalty tax' of 35% or 45%, which applies on non-deductible, cash expenses. In this area, the Chilean Tax Administration exerts significant levels of discretionary power, so caution is advised.

## Thin capitalization

Chile's tax legislation provides for a general thin capitalization rule by which outbound related party interest payments otherwise qualifying for the reduced 4% withholding tax rate will be subject to a 35% penalty rate if paid in a tax year in which the debtor was in an excessive indebtedness position

---

Second, taxation at the second level takes place only when business profits are withdrawn or distributed to the ultimate business owners (resident individuals who are partners or shareholders of the business entity, subject to Surtax or *Impuesto Global Complementario*, whereas non-resident individuals or foreign juridical entities which are partners or shareholders are subject to the Withholding Tax or *Impuesto Adicional*). The effective rate payable on profits remitted abroad to a non-resident partner or shareholder, as the case may be, is normally 35% (21% being payable at the time profits were accrued at the corporate level with the 14% balance (35%, less 21% credit) due on payment or remittance or profits overseas).



(defined as debt that exceeds three times the debtor's equity). Whether or not this thin capitalization rule applies to funds is currently the subject of technical debate, and the Chilean Tax administration has not issued official interpretations on the subject. Caution is therefore also advised.

## 21. What forms of exit are available?

In a solvent situation the most common exits are through IPOs or trade sales. In theory, a private equity house could also exit through the issue of American Deposit Receipts (ADR) or a similar scheme. Put options, tag and drag along rights are also common.

In an insolvent situation the control of the portfolio company is very limited. The trustee appointed by the Court in relation to the bankruptcy becomes the administrator of the assets subject to the sequestration, while the debtor loses management of the assets. Possible exits would be the sale as an 'entire business' and judicial or extra-judicial settlements.

## Colombia

### 1. What structures do private equity funds typically use to manage their funds?

The choice of structure for private equity funds in Colombia usually depends on whether the fund will target investments from Colombian institutional investors (e.g., pension funds and insurance companies) and its investment policies (i.e., whether it intends to invest in Colombian publicly listed securities). Private equity funds typically use *fondos de capital privado* (literally, ‘private equity funds’) a special type of vehicle established by Colombian law to allow Colombian institutional investors to invest in assets or rights other than Colombian-registered securities.

Colombian private equity funds must have at least two investors, who must invest at least 600 minimum monthly salaries (approximately USD 195,000), in aggregate. Investors receive ‘units’ representing their membership interests in the private equity fund which, depending on the bylaws of the fund, may or may not be publicly traded. In practice, pension funds and other regulated institutional investors require that the units in the private equity funds be registered securities.

Because the tax treatment afforded to institutional investors and foreign investors is different (institutional investors are, generally, not subject to Colombian income tax, while foreign investors are), many Colombian fund managers with both Colombian institutional investors and foreign investors establish two parallel vehicles within the overall fund structure (i.e., a Colombian private equity fund and an offshore limited partnership structure typically established in a jurisdiction such as the Cayman Islands) that enter into a parallel investment agreement.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in Colombia?

Unlike other Colombian portfolio investment funds, Colombian private equity funds do not require an express authorization from the *Superintendencia Financiera de Colombia* (FSA) to be incorporated. Instead, the relevant fund administrator must submit the following information to the FSA prior to the start of operations of the private equity fund:

- (a) the draft of the private equity fund’s bylaws (the equivalent to the limited partnership agreement used in other jurisdictions);
- (b) a copy of the minutes of the board of directors of the fund administrator that approves the creation of the private equity fund;
- (c) a certificate from the legal representative of the fund administrator indicating that it complies with the authorization requirements;
- (d) a facsimile of the document that evidences the investor’s interest in the private equity fund; and
- (e) the profile of the persons that will participate in the investment committee and who will manage the private equity fund.

The fund is deemed to be authorized if the FSA does not state otherwise within 10 days after the filing of the information. After its authorization, a private equity fund is subject to the regulatory control of the FSA.

From a regulatory perspective, a Colombian private equity fund may only be established and administered by the fund’s administrator. Only Colombian broker-dealers (*sociedades comisionistas de bolsa*), trust companies (*sociedades fiduciarias*) and investment management companies (*sociedades administradoras de inversion*) are authorized to act as fund administrators. In practice,



however, the initiative to establish a Colombian private equity fund rarely comes from the fund's administrator. Typically it is the fund's prospective manager who will take that initiative and, at some point in the fund's promotion process, engage a registered broker-dealer, trust company or investment manager to act as the fund's administrator.

Broker-dealers, trust companies and investment management companies are all entities that must be created and operate under Colombian regulations and are under the supervision of the FSA. The scope of what they can and cannot do is limited to what is expressly authorized under Colombian law. While broker-dealers and trust companies are heavily regulated in their incorporation and operation, investment management companies are less so. However, these entities must be incorporated following the same steps applicable to other financial entities and must have a significant minimum capital.

As a general rule, a trust company, broker-dealer or investment management company relies on an expert to make the investment decisions, manage the investments and control the exit process. This expert is a *gestor profesional*. The *gestor profesional* of a Colombian private equity fund (which carries out the fund's investment management activities and has powers and duties similar to those of a general partner in a traditional private equity fund structure) does not have to be licensed. It may be an individual or entity, Colombian or foreign, that is an expert in the management of funds and in the type of assets that the particular private equity fund will hold. The fund administrator must have sufficient experience and be well-known in Colombia or abroad, and must comply with the experience, knowledge and reputation requirements described in the private equity fund's bylaws. Whether a fund manager meets the criteria set out in the fund's bylaws is a matter to be verified by the applicable trust company, broker-dealer or management investment company that set up the fund and retained the services of the fund manager. However, in practice, funds are set up at the request of fund managers and therefore the bylaws are tailored to allow the applicable fund manager to meet the criteria set out in the bylaws.

### 3. Are there any approvals required for investments by foreigners in Colombia and, if so, what is the process?

#### Foreign investment

Foreign investments are permitted in all areas of the economy with the exception of activities related to defense and national security, and the processing and disposal of toxic, dangerous or radioactive waste not generated in the country. A Colombian company can be 100% foreign-owned, except for foreign investment in national broadcast television which is limited to a maximum of 40% ownership of the relevant operator.

Foreign investments in Colombia do not require prior government approval. They must, however, be registered with the Central Bank either automatically on receipt of currency in the country or by filing the relevant documents within the applicable term with the Central Bank. Registration of foreign investment guarantees gives the foreign investor access to the foreign exchange market to purchase convertible currency to remit dividends and repatriate the investment. The failure to report or register could result in the imposition of fines and could imply that the investor would have to rely on the free market for access to convertible currency. The registration of foreign investment must be annually updated with the Central Bank.

#### Exchange controls

The Central Bank is the authority on monetary and exchange matters.

#### 'Compensation' accounts

Unless the law specifically permits otherwise, the general rule is that payments between Colombian companies or individuals must be made in Colombian Pesos, or between overseas foreign currency

accounts duly registered with the Central Bank, known as ‘compensation’ accounts. In general, Colombian banks do not offer foreign currency accounts. However, Colombian residents are allowed to maintain accounts in foreign currency abroad for the performance of all types of operations. If the account is used to perform controlled operations, the foreign currency account must be registered with the Central Bank as a ‘compensation’ account and the movements of these accounts must be reported to the Central Bank and to the tax authorities on a monthly or quarterly basis. Failure to do so within the legal term will trigger fines against the account holders.

#### *Controlled operations*

All foreign currency for the operations listed below must be acquired or handled through the so-called ‘exchange intermediaries’ (i.e., Colombian banks, some financial institutions and foreign exchange intermediation companies, formerly known as exchange houses) or by using registered offshore accounts:

- (a) import and export of goods;
- (b) foreign loans and related earnings;
- (c) foreign investments in Colombia and related earnings;
- (d) Colombian investments abroad and related earnings;
- (e) financial investments in securities issued or assets located abroad and earnings related to them, except when investment is made with currency originating from ‘free market’ operations (i.e., operations that the law does not require to be made through the exchange market);
- (f) guarantees in foreign currency; and
- (g) derivatives.

All other foreign currency operations may be made through the exchange market or the so-called ‘free market’. In general, Colombia regulations do not allow for the set-off of the payment obligations resulting from these transactions.

#### *Exchange declaration*

Colombian and foreign residents who perform an exchange operation through the Colombian exchange market must complete and file an exchange declaration. The exchange declaration must be submitted to a commercial bank or an authorized financial institution, which will then forward it to the Central Bank. In some cases, the law will require filing of the exchange declaration directly with the Central Bank.

#### *Foreign loans*

Colombian residents may obtain loans in foreign currency from Colombian banks or from any overseas entity, and may use such currency for any legal purpose. The parties are free to agree on the terms and conditions of the loan. All foreign lenders must register with the Central Bank, either simultaneously with, or prior to, disbursement. The debtor must register the foreign debt with the Central Bank. Direct intercompany loans granted by non-Colombian parent companies to their Colombian subsidiaries are permitted. Colombian subsidiaries may also loan funds to their foreign parent companies or affiliates.



#### 4. Who are the relevant regulators in Colombia and how much interaction would one generally expect when undertaking a buyout?

Transactions may be subject to other regulators depending on the nature of the parties, the target or the industry.

The regulators that are typically encountered are:

- (a) the *Superintendencia Financiera de Colombia (FSA)* - for investments of 10% in companies in the finance sector or for the takeover of listed companies or any operation where over 25% of the securities are acquired, or if a further 5% is acquired by shareholders already holding more than 25%;
- (b) the *Superintendencia de Sociedades* - the Colombian corporate regulator;
- (c) the *Banco de la República (Central Bank)*;
- (d) the Trade and Industry Superintendency - for antitrust clearance;
- (e) other regulatory commissions - such as the Telecommunications Regulatory Commission for certain investments in the telecommunications sector;
- (f) the Colombian Stock Exchange - for the acquisition of publicly traded shares; and
- (g) the tax and customs authorities (**DIAN**).

The level of involvement depends on the transaction. If it does not involve an investment in a company with listed securities or an otherwise regulated entity and there is no market integration (i.e., the purchaser and the target do not participate in the same relevant markets), there may be no prior authorization required or involvement of regulators. The DIAN does not authorize or prevent transactions.

#### 5. How are buyouts typically undertaken in the private and the public markets?

A buyout of a private company is usually undertaken by a negotiated acquisition. Sale and purchase documents for a sale of share or assets regulate the obligations and liabilities of the parties.

A buyout of a listed company can be achieved by a tender offer or bid regulated by the FSA and the Colombian Stock Exchange. Alternatively companies can be delisted (subject to the applicable FSA and Colombian Stock Exchange regulations) and then sold.

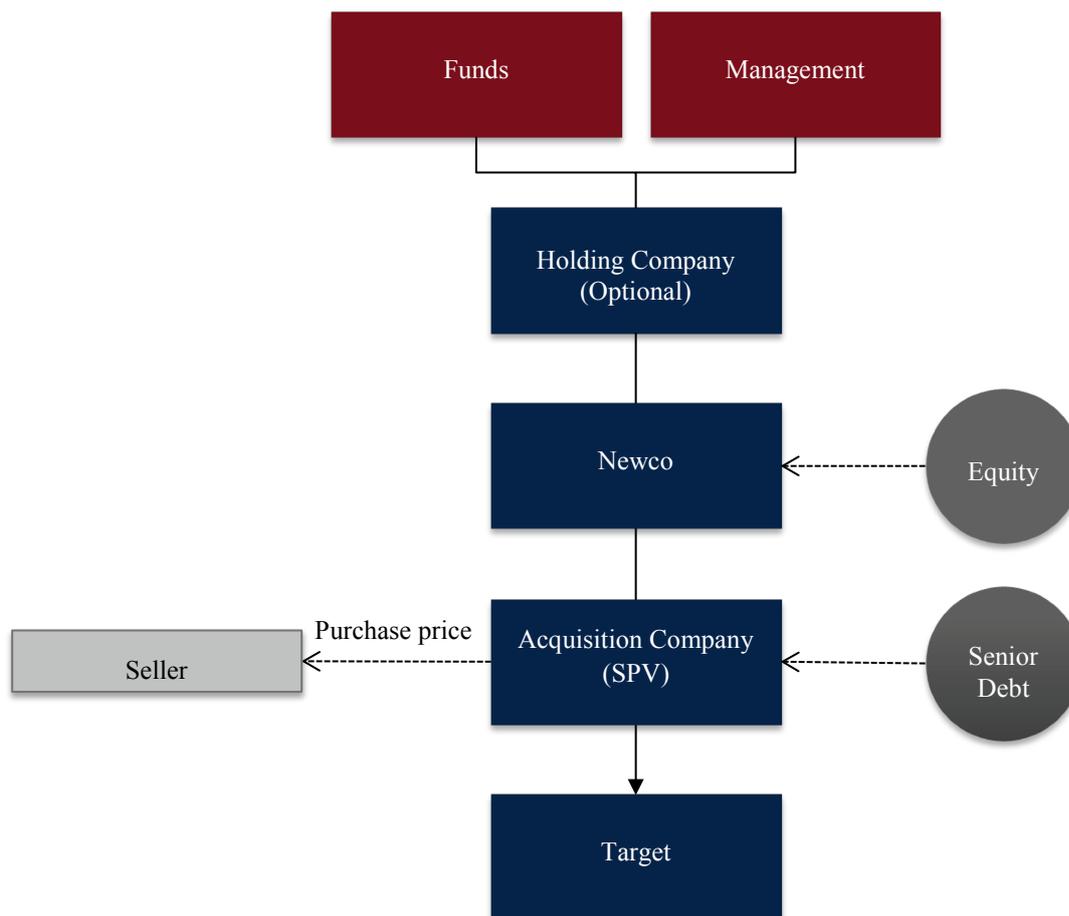
Going private transactions are extremely rare, because the typical Colombian target portfolio company is not listed on the Colombian Stock Exchange. In fact, mergers and acquisitions activity in Colombia is dominated by private transactions, as only a handful of transactions involve listed companies. (e.g., in the last two years only 10 public tender offers took place).

While many private equity transactions include the possibility of an IPO, and some shareholders agreements even regulate the terms and conditions of an eventual future IPO in significant detail, IPOs remain extremely rare as an actual exit strategy. This is probably because of the relative immaturity of the Colombian securities markets.

#### 6. What is the typical corporate structure used when doing a buyout?

Acquisition structures of private equity transactions are mostly tax driven, usually structured with an indirect sale strategy in mind (i.e., at exit, the private equity shareholder will sell the shares of an offshore holding vehicle, and not the shares of the portfolio company itself), primarily because indirect sales of shares in Colombian companies are not taxed in Colombia. The jurisdiction of the

offshore holding vehicle is chosen on the basis of several considerations, including the Colombian double taxation treaty network.



Although acquisition structures do vary from transaction to transaction, it is fairly common to use a special purpose Colombian Acquisition Company where the equity contributions by the private equity fund (or its various vehicles, in the parallel fund structure described in the answer to question 1), together with debt secured at the Acquisition Company level, can be used to acquire a direct interest in the Colombian Target.

This structure allows for the consolidation of the equity contributions by the various fund vehicles into a single acquisition vehicle (Newco or Acquisition Company), and the push down of the acquisition debt to the target by way of merger between the relevant acquisition vehicle and the Target.

Newco and the Acquisition Company will typically be incorporated as a Colombian entity. After the acquisition, it is usually the case that Newco/Acquisition Company is merged with the Target.

## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

#### *Private sales*

A sale and purchase agreement of the shares or assets is the main document for the buyout of a private company. It is not uncommon for the original owners to retain a partial interest in the target portfolio company, so private equity transactions in Colombia may also involve shareholders agreements



regulating the governance of the company and the rights and obligations of the parties in relation to their shares.

#### *Public tender offer*

For listed companies (where the transfer of shares can only take place pursuant to a public tender offer through the stock exchange), the bidder enters a written undertaking to launch a public tender offer on the pre-agreed terms and conditions. Public tender offers are mandatory when:

- (a) any person (or group of persons sharing the same beneficial owner) intends to acquire shares representing 25% or more of the voting shares of a company listed on a Colombian stock exchange;
- (b) any person (or group of persons sharing the same beneficial owner) who already owns 25% or more of the voting shares of the relevant company intends to increase its voting shares by more than 5%;
- (c) any person (or group of persons sharing the same beneficial owners) acquires voting shares representing 25% or more of the target company as a result of a merger, in Colombia or abroad (in which case an '*ex-post*' public tender offer must be launched within three months of the transaction, unless the purchaser divests the relevant shares within three months of the merger);
- (d) any person (or group of persons sharing the same beneficial owners) holds more than 90% of the shares of the relevant listed company, if:
  - (i) this threshold was reached by means other than a public tender offer for all of the shares in the company; and
  - (ii) the minority shareholders owning at least 1% of the voting shares of the target company request that a public tender offer is launched (in which case the public tender offer must be launched within three months of the date on which the 90% threshold was exceeded); and
- (e) the shareholders of the relevant listed company decide to delist the company by a majority shareholder vote (as opposed to a unanimous shareholder vote).

Shareholders that are not part of the selling group are at liberty to decide whether to accept the tender offer or not. Competing bids may result because the pre-agreed terms must be disclosed to the market well in advance of the actual closing and any other party could submit a competing tender offer.

In both types of buyouts (i.e., private sales and public tender offers), the agreements can include customary stipulations, such as representations and warranties from the sellers regarding the shares and the target, and any relevant indemnification obligations. Further, there may be ancillary documents such as an escrow agreement, shareholders agreement or transitional services agreement.

## Banking

Senior and subordinated financing arrangements are common. When the senior and subordinated facilities are not granted by a syndicate of loans, the two types of facilities are documented separately and an intercreditor arrangement is used to tie both agreements together.

Intercreditor arrangements are customary where creditors benefit from common security, so as to restrict individual creditors taking enforcement action in respect of any common security, agreeing on the circumstances when common security may be enforced and what time periods need to be observed prior to creditors taking enforcement action. Intercreditor agreements for transactions where lender groups do not share in security are less common.

Where different lenders have provided financing to a borrower and the lenders are not subject to an intercreditor arrangement, each lender (or lender group, as the case may be) is free to enforce its security, accelerate its facility and make a demand on the borrower for payment (which may ultimately lead to that lender filing a claim for the insolvency of the borrower) without consulting, or seeking the consent of, the other lenders.

Security can be held by a security trustee for the lenders on the basis of a separate security trust agreement or by granting a pledge over shares or assets. Security is typically by way of a pledge of the target's shares, a guarantee by the target and a fixed and floating charge over the assets of the target. Putting this security package in place can be a challenge because security granted by the target can usually be put in place only after the acquisition closes, which means that the lender may be relative unsecured for a brief moment (between disbursement of the loan and closing of the acquisition).

## 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

In private deals, negotiated warranty and indemnity coverage is usually obtained from sellers both for share and asset sales, with thresholds, caps and time limits.

As opposed to private sales (where representations and warranties are provided as a general rule by all selling shareholders), in public tender offers the representations and warranties are provided as a general rule by the shareholders or group of shareholders driving the sale process, and not by the adhering shareholders.

Until recently it was fairly common to obtain a general survival period of three years from private sellers and survival periods extending to the applicable statute of limitations for tax claims (up to five years) and an extended survival period for environmental claims (also five years, though the statute of limitation for fines is 20 years). Under the influence of private equity and other more sophisticated players, the general survival period is now more commonly 18 to 24 months. We expect the general survival period to shrink even more once the expected first exit cycle of private equity investors takes place, as private equity investors will seek even shorter survival periods. Caps are becoming lower as well. While non-sophisticated sellers are likely to agree to a 100% cap, sophisticated and well-advised sellers are likely to bargain for caps ranging from 10% to 20% of the purchase price as a general rule. Escrows are becoming the rule to secure indemnification obligations.

Another typical form of protecting a buyer before closing an acquisition is via conditions precedent. Generally, a fund manager includes several conditions precedent to closing that are not limited to fundamental conditions, but also to actions to be taken by a seller to correct or mitigate adverse findings identified at the due diligence stage. The use of non-fundamental conditions precedent is more common in private transactions. However, as market participants become more sophisticated, this greater umbrella of protection for buyers is expected to narrow.

In line with what has been happening in other, more mature markets, insurance companies in Colombia have begun offering representations and warranties insurance products (R&W or W&I insurance products), and dealmakers have been considering this type of insurance seriously.

## 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

While a manager or director remains employed by the target company, they must maintain their fiduciary duties to the company. Colombian law imposes obligations on the management of the company, including managers (those authorized to represent the company *vis à vis* third parties and that handle the day-to-day business of the company), directors and any others with similar powers and duties. They must act in good faith, not misuse their position to advantage themselves nor improperly



use information of the company for their own gain. During negotiations, administrators who find themselves with a conflict of interest must not participate in the relevant decisions.

Shareholders must approve management conflicts of interest. Majority shareholders are not permitted to approve the conflict unless the proposed action by the management is not detrimental to the company. For example, if the financing for a leveraged buyout is secured by the target company's assets and not all shareholders are selling, it would be questionable whether the conflict of interest could be approved without having the seller shareholders or the buyer providing consideration on arm's length terms to the target company to secure the financing.

In addition, an administrator has joint and several liability for the damages suffered by the company, shareholders or third parties as a result of its negligence and willful misconduct, except where it had no knowledge of the act or omission, or voted against it and did not carry out the relevant act. Any attempt to limit or exonerate an administrator from this type of liability in the bylaws is null and void. Therefore, an administrator must analyze cases in which there may be a conflict of interest carefully and when necessary declare itself unable to vote.

## 10. How are the equity arrangements typically regulated in a buyout?

Equity arrangements are typically regulated in the shareholders agreement and protection is set out in the bylaws. The shareholders agreement is enforceable among the shareholders and, if a copy of the agreement is deposited with the target company by delivery to the CEO or the equivalent, it will also be enforceable against the company (even if the company is not a party to the agreement, at least in connection with voting rights and other governance matters). However, if the shareholders agreement refers to transfer restrictions or rights and is not limited to voting provisions, it is advisable to have the company included as a party.

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

A Colombian company (i.e., a limited liability company (*sociedad anónima*) (SA) or a simplified shares corporation (*sociedad por acciones simplificada*) (SAS) may issue:

- (a) common shares, which grant ordinary rights to shareholders (e.g., right to vote, to receive dividends, to negotiate shares, right of inspection of the records of the company and the right to receive assets on liquidation);
- (b) privileged shares, which grant to their holders additional economic rights (e.g., preferential right to receive reimbursement on liquidation (up to their face value), a preferential right to receive special dividends and other economic benefits); and
- (c) shares with non-voting rights that grant preferred dividends. Companies may, for example, issue shares without voting rights that grant preferred dividends (used for capital investors), but this type of share cannot represent more than half of the outstanding capital of the corporation. If a company is regulated, for example because its shares are listed or has issued securities pursuant to public offerings, or exceeds certain revenue or asset thresholds, the issue of this type of share may require prior clearance from the relevant regulatory body.

In relation to equity securities in an SAS, parties are granted even greater freedom to define the rights and benefits of any non-common shares. These rights and benefits may be in addition to, or different from, the rights and benefits listed at (a) to (c) above.

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

### SA

An unlisted SA must have a board of directors composed of at least three principal members and three alternates. The shareholders appoint the members of the board. Directors are elected by an electoral quotient system<sup>7</sup>. In the case of companies with listed securities, there must be a minimum of five and a maximum of ten principal members and alternates. At least 25% of the directors must be independent.

In principle, the powers of the board of directors of an SA can be freely determined in the bylaws, and unless the bylaws provide otherwise, the law presumes that the directors have all necessary powers for the company to carry out its corporate purposes. Issues such as the appointment and removal of directors are typically included in the shareholders agreement, although any provision in the shareholders agreement or the bylaws completely blocking the right of removal of directors is not valid.

In general there are no residency requirements for directors or managers except with respect to financial institutions (where a majority of the directors and managers need to be Colombian residents due to a non-official position of the FSA that has the power to confirm or deny management appointment positions). Note that individual directors may not hold more than five board positions.

Differential director voting rights are allowed but are not common.

### SAS

An SAS is not required to have a board of directors, but may have one if so decided by the shareholders. A simplified shares corporation has great freedom to determine governance rules but its shares cannot be listed and there are certain types of activities that can only be carried out by a traditional shares corporation such as an SA (e.g., an SAS cannot be a utilities company or a financial institution). An SAS with a board of directors must appoint at least three directors who must all be natural persons.

## 13. What measures are commonly used to give a fund some level of control over key operating and financial decisions made by a portfolio company?

The method most commonly used to give a fund some level of control over key operating and financial decisions made by a portfolio company is to establish controls in the shareholders

---

<sup>7</sup> This system consists of dividing the number of voting shares at the meeting by the number of directors to be elected to obtain the electoral quotient (EQ). For example, if there are five directors and 100 votes the EQ will be 20. A list of candidates is submitted by each shareholder or group of shareholders. The number of votes obtained for each list is divided by the EQ to determine how many times the EQ has been covered by the votes. For each time the EQ has been covered by the votes cast on any given list, one candidate on that list will be elected. Where a position of director remains to be filled, the list with the highest remainder will elect the director, and so on until all the directors have been appointed. If we assume that three lists were submitted and the first one got 49 votes ('List A'), the second one 31 votes ('List B') and the third one 20 votes ('List C'), then in an initial round, List A would obtain two directors (because List A obtained votes amounting to two full EQ), List B one director (obtained votes amounting to one full EQ) and List C one director (obtained votes amounting to one full EQ). This means that four directors were appointed directly by the application of the EQ factor. The remaining director will be appointed from the list with more residual votes after subtracting the EQ votes that resulted in the directors appointed as explained above. This means that the fifth director is appointed by List B, which got 11 residual votes, as opposed to List A which got nine residual votes and List C, which got one residual vote.



agreement. Many such controls are also reflected in the bylaws of the company, especially in relation to special majorities. Veto rights that are part of shareholders agreements are generally reflected in the bylaws if the veto is agreed on in the form of a special supermajority. Where the veto is tied exclusively to a shareholder, regardless of the shareholder's participation or as long as that shareholder maintains a minimum participation in the company, the veto right is, as a general rule, only included in the shareholders agreement and not in the bylaws. Prior authorizations of the board or the shareholder/partners for certain financial operations and major transactions are frequently required in the bylaws.

#### 14. What employment terms are generally imposed on management in a buyout?

Usually senior managers have an indefinite term employment agreement providing for certain rights on dismissal, among other things, under Colombian law. The existing employment agreement with senior management may be amended to include the new provisions in relation to performance-based bonuses or options (specifying fixed or salary components and non-salary components, such as bonuses). Stock options are usually addressed in a separate agreement.

#### 15. What incentives can be offered to management and how are they typically structured?

Incentives such as bonus schemes or options over equity of the company are most frequent, often with a ratchet depending on events such as performance or sale price in the event of an IPO.

#### 16. How are buyouts typically debt financed and secured?

Buyouts are typically financed with debt. Debt financing depends on the transaction and market conditions at the time. In principle, Colombian residents are allowed to freely obtain loans (domestic or foreign) to finance acquisitions.

As mentioned in question 6, acquisition financing is usually obtained at the acquisition company level (i.e., the special purpose vehicle (Newco or Bidco) used to acquire the target shares that ends up being the holding company of the target) and then pushed down to the target by way of merger between that acquisition vehicle and the target company.

Security is typically by way of a pledge of the target's shares, a guarantee issued by the target, and a fixed and floating charge over the assets of the target. Creating this security package can be a challenge because security granted by the target can usually be put in place only after the acquisition closes, which means that the lender may be relatively unsecured for a brief period between disbursement of the loan and closing of the acquisition.

#### 17. Are there financial assistance issues to consider when undertaking a buyout?

There is no prohibition on a company incorporated in Colombia providing financial assistance unless the target company is:

- (a) a bank (*establecimiento bancario*);
- (b) a finance corporation (*corporación financiera*);
- (c) a financing company (*compañía de financiamiento*);
- (d) a financial cooperative (*cooperativa financiera*);
- (e) a financial services company (*sociedad de servicios financieros*);

- (f) a capitalization company (*sociedad de capitalización*);
- (g) an insurer;
- (h) an insurance broker; or
- (i) a reinsurance broker.

Colombian law does not, in general, prohibit financial assistance in connection with the acquisition of shares in the assisting company or its parent company. However, Article 10(c) of the Colombian Financial System Statute (*Estatuto Orgánico del Sistema Financiero*) prohibits the entities listed above from directly or indirectly financing the acquisition of shares (or bonds convertible into shares) in that financing entity (or of any other financial or insurance company in Colombia).<sup>8</sup>

Regular commercial companies are not subject to any financial assistance limitations. However, the Colombian *Superintendencia de Sociedades* (Colombian corporate regulator) has stated that in order for a company to grant loans, granting loans activity must be expressly included in its corporate purpose as an ancillary activity and the loan must pass a ‘means-ends’ test, (i.e., it should be possible to demonstrate that the loan serves the corporate purpose of the company).

## 18. What are the implications under the corporate benefit laws of Colombia for a company providing financial assistance?

While Colombian commercial companies may provide loans and financing, in general, administrators and officers of companies are subject to ‘fiduciary’ duties under the law. Law 222/1995 (which modified the Colombian Commercial Code (Decree 410/1971 as amended)) requires administrators or officers of a company to act in good faith and loyally towards the company, and sets out the duty of administrators and officers to act in the interests of the company, while also considering the interests of the partners/shareholders. Administrators and officers may be held liable if any financial assistance they approve or implement fails to meet these standards.

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

The general rule is that secured creditors rank ahead of unsecured creditors who, in turn, rank ahead of shareholders. Liabilities of any debtor under insolvency proceedings are to be paid in the following order of priorities:

- (a) expenses incurred after the commencement of an insolvency proceeding;
- (b) pension liabilities;
- (c) liabilities covered by a security interest on personal property up to the amount of the security interest over the personal property. Security interests granted over movable property is serviced on a first-perfected, first-serviced basis. A purchase-money security interest will take precedence over a floating security interest that was first perfected;
- (d) labor liabilities (although constitutional challenges that are yet to come may result in Colombian courts giving priority to labor liabilities over secured creditors);
- (e) general tax obligations;
- (f) liabilities covered by a mortgage;

---

<sup>8</sup> Unless: (a) the shares are acquired in a primary way or under privatization; and (b) the loan is guaranteed with collateral having a commercial value of at least 125% of the financed amount.



- (g) liabilities of tax collectors with tax authorities, liabilities of the debtor with charity or educational institutions funded with public resources and accounts payable to suppliers of inputs or raw materials necessary for the production of goods or rendering of services. The liabilities on this level are paid on a first-accrued, first-served basis;
- (h) other unsecured liabilities; and
- (i) shareholders in relation to their capital contributions.

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

Every transaction must be carefully analyzed to benefit from any tax advantage available because of the type of asset, the situation of the company or the nationality of the parties. Colombia has double taxation treaties under the OECD guidelines with Canada, Chile, Mexico, Spain, Switzerland, India and South Korea. Colombia has also signed treaties with Portugal, and The Czech Republic, which are still undergoing approval procedures, and is in the process of negotiating tax treaties with Belgium, France, Germany, Israel, Japan, The Netherlands, the United Arab Emirates, and the United States of America. The Andean Community treaties (in force with Peru, Bolivia and Ecuador) also contain some double taxation provisions.

The general tax rules to be taken into account in Colombia are set out below.

### Transfer taxes

The transfer of shares in an SA or an SAS (the most common corporate structures in Colombia) is not subject to stamp or other transfer taxes. The transfer of an interest in limited liability companies (*sociedades de responsabilidad limitada*) is subject to a registration tax of 0.7%.

### Deductibility and financing costs

The Colombian tax office considers that the cost of financing obtained for the acquisition of a Colombian company is not deductible in Colombia, unless the dividends distributed by the target are taxable. The rationale behind this is that for an expense to be deductible, it must be necessary to generate taxable income. As a general rule, dividends distributed by Colombian companies are not taxable if the profits associated with those dividends have already been taxed at the portfolio company level.

While this position is debatable, in practice it has led buyers to carry out their acquisitions through special purpose vehicles that receive the financing and are subsequently merged into the target, therefore effectively pushing down the acquisition financing to the target. This option is not available when the acquisition does not result in effective control of the target.

The deductibility of the cost of foreign borrowing from unrelated parties is subject to the same limitations, as well as the requirement that the relevant withholdings of interest are actually performed. There are reasonable arguments to hold that interest payments made to related parties (foreign or otherwise) are also deductible under the same conditions, provided that the transaction also meets transfer pricing regulations in the case of foreign related parties. These requirements include that the transaction is entered into on arm's length terms and that the supporting transfer pricing returns and studies are submitted on demand. This study is by an expert stating that the commercial terms of the financing are on market terms and will be required in any of the following events:

- (a) if the Colombian borrower's net worth is equal to or greater than approximately USD 1,150,000;

- (b) the borrower's income during the preceding fiscal year was equal to or greater than approximately USD 690,000, or approximately USD 115,000 if the lender is located in a tax haven as determined by the Colombian government; or
- (c) the principal amount is equal to or greater than USD 370,000.

These amounts should be reviewed at the time of the transaction because they are indexed to a tax unit value determined by the tax authority in Colombian pesos, adjusted on a yearly basis and converted into dollars or other foreign currency at the exchange rate applicable on the relevant date.

Colombian income tax law does not allow the deduction of interest paid on the amount of loans that, on average during the year, have exceeded a 3:1 debt to equity ratio if compared to the net tax equity of the taxpayer as of the end of the previous year. The debt will be determined as a weighted average of the borrowed amounts according to its duration in the fiscal year, under the methodology provided by the government. This limitation affects not only debts with foreign-related parties but any debt that yields interest.

### Withholding tax

As a general rule, interest paid on foreign loans granted for a term of one year or more is subject to a 14% income tax withholding. Interest paid on domestic loans will be subject to a 2.5% income tax withholding.

The law provides certain exceptions with respect to interest paid on loans granted for a term of less than one year as follows:

Financial Year	Rate
2015	39%
2016	40%
2017	42%
2018	43%

In 2019 and the subsequent years the withholding rate is set to decrease to 33%.

Reduced withholding rates are available under double taxation treaties. Colombia currently has seven double taxation agreements (**DTA**) in force, with Spain, Canada, Chile, Switzerland, Korea, India and Mexico. In general terms, DTAs provide a reduced withholding rate for payments to lenders domiciled in one of these jurisdictions, as follows.

	Non-financial entity creditor	Financial entity creditor
Mexico	10%	5%
Spain	10%	0%
Chile	15%	5%
Canada	10%	10%
Switzerland	10%	0%
India	10%	10%
Korea	10%	10%



Therefore, a lender group lending money to a Colombian borrower, to the extent possible, should try to fund the loan through one of its affiliates organized in one of the above jurisdictions to benefit from withholding.

Dividends paid by a Colombian company to its shareholders (either resident or non-resident) are not subject to withholding tax, provided that the relevant earnings of the company paying the dividends have been subject to the applicable income tax. If not, those dividends would be subject to a withholding tax in the following percentages:

Financial Year	Rate
2015	39%
2016	40%
2017	42%
2018	43%

In 2019 and the subsequent years the withholding rate is set to decrease to 33%.

If dividends are to be paid to a shareholder resident of country in which one of the mentioned double taxation agreements is in force and where dividends were not taxed at the company level, the general rule is that the only tax applicable will be the amount of tax withheld in Colombia, except for payments to shareholders in jurisdictions that offer more beneficial withholding rates as set out in the table below:

Country	Withholding rate
India	5%
Canada	5% if the beneficiary holds at least 10% of the shares with voting rights (directly or indirectly) and 15% in all other cases.
Switzerland	0% if the beneficiary holds directly at least 20% of the shares with voting rights and 15% in all other cases.

### Income tax on disposal

As mentioned in the answer to question 6, it is common for private equity shareholders to try to structure their acquisitions so that they can dispose of them indirectly (by selling the shares of an offshore holding vehicle and not the shares of the Colombian portfolio company) because, in principle, indirect sales of shares in Colombian companies are not taxed in Colombia.

Assuming the disposal is structured as a direct sale of shares of the Colombian portfolio company, the profits derived from the sale of shares will be taxed at a rate of 10% if the seller has held the shares for a minimum of two years, or at a rate of 34% if the seller has held them for less than two years.

The sale of shares of a listed company will not be taxed if the shares sold by the relevant shareholder within the relevant fiscal year represent less than 10% of the issued and outstanding shares of the company.

## 21. What forms of exit are available?

In a solvent situation, the most common exits are negotiated sales. While IPOs are generally contemplated by private equity funds, they still remain uncommon.

Exits in an insolvency situation are rather uncommon. However, an exit in relation to an insolvent company is more likely to be structured as an asset deal that requires:

- (a) the approval of the insolvency court; and
- (b) that the proceeds be placed at the disposal of the insolvency court for the payment of those liabilities not included in the transaction or not attaching to the transferred assets.



## Czech Republic

### 1. What structures do private equity funds typically use to manage their funds?

The majority of Czech private equity funds are structured as limited partnerships or limited liability companies outside the Czech Republic due to more favorable tax conditions. These private equity funds, in turn, typically use a Czech or foreign special purpose vehicle acquisition vehicle (**SPV**) when structuring their transactions.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in the Czech Republic?

Typically, foreign-based private equity funds do not have to be licensed in the Czech Republic to conduct business, (i.e., to invest in portfolio companies) nor do they need to appoint Czech-based advisors or asset managers.

However, consultancy services regarding investments that are marketed to persons in the Czech Republic are a regulated investment. Therefore the provider of those services must either operate under an EEA (EU) passport or be licensed by, or registered with, the Czech National Bank.

### 3. Are there any approvals required for investments by foreigners in the Czech Republic and, if so, what is the process?

Other than what is set out below, there are generally no restrictions on foreign investment in the Czech Republic (subject to a very few exceptions, e.g., arms dealing). In general, no government approvals are required specifically for foreign investment, although approvals from the Czech National Bank may be required in respect of certain transactions (set out below). This consent is required regardless of whether the investor is a local or foreign person.

#### Qualified entities

Under Czech law, prior approval from the Czech National Bank is required if a person, or persons acting in concert, acquire or increase their share in, or become a controlling person of, the following financial institutions (**Qualified Entities**):

- (a) Czech-based banks, electronic money institutions and cooperative saving companies;
- (b) investment firms, investment companies, self-governing investment funds and main administrators of Czech and foreign investment funds; and
- (c) insurance and reinsurance companies and pension companies.

Specifically, consent is required in relation to:

- (a) the direct or indirect acquisition of a qualifying holding in a Qualified Entity, (i.e., a shareholding in the Qualified Entity representing 10% or more of its registered capital or voting rights or any shareholding allowing the person(s) to exercise a significant influence over the management of the Qualified Entity);
- (b) the increase of a qualifying holding in a Qualified Entity so that it reaches or exceeds the 20%, 30% and 50% threshold; or
- (c) the person or entity becoming a 'controlling person' of the Qualified Entity.

Furthermore, a person or persons acting in concert must notify the Czech National Bank without undue delay if they:

- (a) are reducing their qualifying holding in a Qualified Entity or are completely disposing of it; or
- (b) are reducing their qualifying holding in a Qualified Entity so that they will cease to control it.

### Squeeze-out

A shareholder with a 90% or more shareholding in the registered capital and voting rights of a joint stock company may squeeze-out the minority shareholders.

If the securities of the joint stock company are traded on a European public capital market, the decision of the general meeting approving the squeeze-out is subject to approval by the Czech National Bank.

### Acquisition of voting rights in a Czech-listed company

The acquisition of a certain share of voting rights of a listed Czech company, as well as exceeding or decreasing the share in the issuer above or below specified thresholds (currently 5%, 10%, 15%, 20%, 25%, 30%, 40%, 50% and 75%) must be notified both to the issuer and to the Czech National Bank. If the registered capital of the issuer amounts to more than CZK 100,000,000 or a foreign currency equivalent, the notification requirement applies on the acquisition of a 3% share of the voting rights.

### State of emergency in relation to the FX economy

If the monetary stability of the Czech Republic is imminently and seriously endangered, the Government of the Czech Republic may declare a so-called state of emergency in relation to the FX economy. In those circumstances, it is, *inter alia*, forbidden to sell Czech securities to foreign persons.

## 4. Who are the relevant regulators in the Czech Republic and how much interaction would one generally expect when undertaking a buyout?

Generally, the level of involvement of regulatory and supervising authorities differs depending on whether the target is listed on the public capital markets, the value of the target's and acquirer's turnovers, and the specific nature of certain regulated industries.

Generally, supervising authorities include:

- (a) the Czech National Bank;
- (b) the Office for Protection of Economic Competition;
- (c) the tax authorities; and
- (d) the Prague Stock Exchange.

The Czech capital markets, including the Czech stock exchanges, are supervised by the Czech National Bank. Czech stock exchanges, nevertheless, possess certain self-regulatory authority because they may adopt rules applicable to transactions carried out on the stock exchanges.

There is no corporate regulator, *per se*, in the Czech Republic. Czech-based legal entities and certain foreign legal entities must, however, be registered in the Commercial Register maintained by the relevant local register courts. These courts supervise registered legal entities with respect to their compliance with corporate registration related duties.



## 5. How are buyouts typically undertaken in the private and the public markets?

### Private market

In a private context, transactions are usually undertaken by way of negotiated acquisition. That is, negotiated sale and purchase documents are prepared, negotiated and executed and those documents record the terms of the sale and acquisition and the rights and liabilities of the parties.

### Public market

A great majority of companies listed on the Czech public capital markets are dominated by one shareholder (or parties acting in concert) holding 40% or more of the voting rights. Due to this concentration of ownership of shares, control over a company can be acquired via a direct purchase of shares from the majority shareholder(s). The same ownership structure is also common in cases of privately held companies.

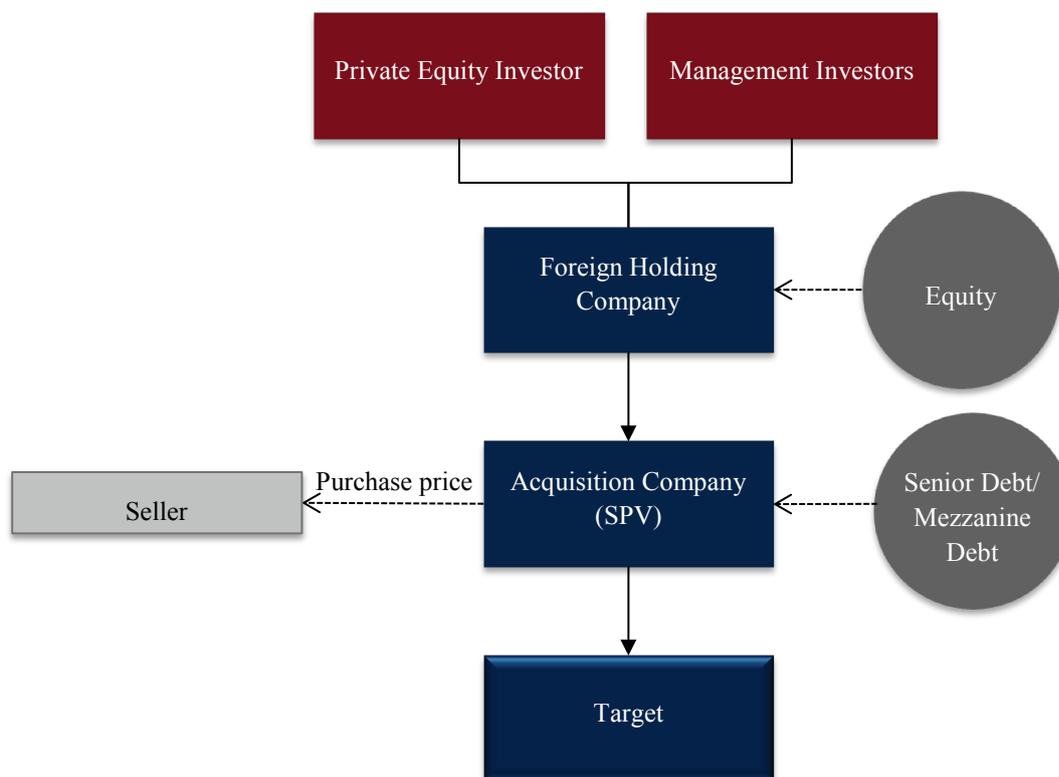
Hostile takeover bids are not common in the Czech Republic. Buyouts are negotiated on an individual basis directly with the controlling shareholder. In practice, tenders organized by sellers are most common. Nevertheless, one-to-one transactions are also still quite common, especially in the case of SME buyouts.

As a general rule, anyone who acquires a share in a joint stock company the securities of which are traded on a European public capital market representing 30% or more of all votes in the listed target is required to make a mandatory takeover bid to the remaining shareholders of that listed target in relation to those listed securities. An offer document relating to the mandatory takeover bid is subject to approval by the Czech National Bank. The consideration exchanged for the participating securities acquired as a result of the mandatory takeover bid may be monetary, in the form of securities, or a combination of both. The Czech National Bank may request the person making the bid to submit an expert opinion relating to the consideration for the participating securities, or appoint an expert to prepare the opinion. The Czech National Bank also has discretion to increase the consideration proposed by the person making the mandatory takeover bid.

If a mandatory takeover bid is not required, a bidder may pursue a voluntary takeover bid. If the bidder acquired a 90% or more share in the voting rights of the listed target during a voluntary takeover bid, it is required to make an additional mandatory takeover bid to the remaining shareholders of that listed target in relation to securities of that listed target traded on a European public capital market.

## 6. What is the typical corporate structure used when doing a buyout?

Acquisition structures vary from transaction to transaction. Nevertheless, the most common transaction structure may be summarized as follows.



Due to tax reasons, the majority of Czech private equity funds have their top parent companies located outside the Czech Republic. Dutch, Luxembourg and Cypriot holding entities are typically used. A Czech subsidiary SPV (Acquisition Company) is typically incorporated as the direct investment vehicle.

Senior and mezzanine debt is typically injected at the Acquisition Company SPV level. The equity contribution from private equity funds to the Acquisition Company SPV is usually contributed in the form of subordinated debt. Management may invest in the Acquisition Company SPV alongside the private equity fund. Note, however, that structures without any management equity investors are common in the Czech Republic.

More complex structures exist in individual deals, depending on, in particular, various forms of external financing and tax considerations.

The most common legal forms used for the Acquisition Company SPVs or other group entities in the Czech Republic include:

- (a) a limited liability company (*společnost s ručením omezeným*) (**sro** or **spol-sro**); and
- (b) a joint stock company (*akciová společnost*) (**as** or **akc-spol**).

These companies are non-transparent for Czech tax purposes.

### Limited liability company

A limited liability company may be established by one or more individual(s) or by one or more corporate entity/entities (there is no maximum limit on the number of participants). Shares in a Czech



limited liability company are represented by participation interest. The minimum capital contribution of each participant is one Czech Crown (CZK), although the company founders may decide on a higher registered capital. Before filing a petition for registration of the limited liability company into the commercial register, the whole contribution premium and 30% of each participant's capital contribution must be paid (the remainder of the initial capital must be paid within five years of registration of the company). Subject to certain conditions, in-kind contributions may be made to the company's registered capital.

### Joint stock company

A joint stock company may be established by one or more individual(s), or by one or more corporate entity/entities (there is no maximum limit to the number of shareholders). The shareholders of a joint stock company are not liable for the company's obligations.

The capital stock of a joint stock company is divided into shares, which may be issued in the form of bearer or registered shares. The minimum registered capital of a joint stock company is CZK 2 million. If a joint stock company keeps books in Euros the minimum registered capital of a joint stock company is EUR 80,000.

## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

The key document is the share purchase agreement (**SPA**) or, in case of an asset deal structure, the asset sale and purchase agreement (**APA**).

In addition to the SPA/APA, shareholder agreements, joint venture agreements, escrow agreements and various side agreements are usually entered into depending on the structure of the transaction.

Management or service agreements are usually entered into as part of the transaction.

### Banking

The main external financing document is the senior credit facility agreement under which senior debt facilities are documented.

If subordinated debt is to be provided, the parties enter into subordinated debt related documentation.

Occasionally, funds are provided via a so-called additional monetary contribution to the equity capital of a company. This contribution is provided by the shareholders of the company in addition to the required minimum contributions to the registered capital of the company (e.g., to mitigate the losses of the company). Alternatively, funds may be provided via a formal contribution into the registered capital.

In addition, various security documents (such as share and asset pledges and security assignments) are entered into to secure financing facilities.

Fees are typically recorded in a separate letter and not in the senior facility agreement.

Hedging is frequently documented on the basis of ISDA (International Swaps and Derivatives Association) documentation.

## 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

Key buyer protection is contained in the share purchase agreement. Buyer protection is usually provided in the form of various representations and warranties, indemnities and purchase price adjustment clauses. The scope and extent of the representations and warranties and indemnities vary from transaction to transaction depending on the negotiating strength and experience of the parties. Various caps and floors and other limits are typically agreed in respect of these protective mechanisms.

In addition, the purchaser's claims under the share purchase agreement may be secured by placing a portion of the sale proceeds into escrow or, alternatively, by a bank/parent guarantee (although parent guarantees are rarely used). Bank guarantees are sometimes used to address specific risks. Title insurance may also be available. It is a form of indemnity insurance insuring against financial loss from defects in title to real property and from the invalidity or unenforceability of mortgage loans. Warranty & indemnity insurance is not commonly used in the Czech Republic.

## 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

Czech law provides for certain general obligations related, among other things, to disclosure of conflicts of interest by company directors as well as members of other company bodies. It also provides for the possibility of temporarily suspending the conflicted director from the exercise of their position.

Directors and members of other company bodies (e.g., supervisory board) owe to the company a duty to act with all necessary knowledge, information and care, in the best interests of the company and with the necessary loyalty to the company. When considering whether there is a breach of this duty, it is necessary to take into account how a reasonably careful person would act if he or she were in a similar situation. The business judgment rule applies.

If the directors or members of other company bodies breach these duties, they must hand over to the company any profit acquired as a result of the breach. If that is impossible they must pay a monetary compensation equivalent to the profit acquired. Furthermore, even though the directors or members of other company bodies may be liable to the company, the company may have D&O insurance to protect it in relation to the director's and member's acts and in fact may prefer to call on the insurance than sue the directors. The scope of the D&O insurance depends on the terms and conditions of the particular insurance agreement.

## 10. How are the equity arrangements typically regulated in a buyout?

In a typical buyout, equity arrangements are primarily regulated by a shareholders agreement. Certain matters (e.g., classes of shares, rights connected to different classes, restrictions on the transferability of shares) may also be addressed in the articles of association of the relevant entities.

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

Czech law is very flexible in relation to the issue of various classes of equity securities and a significant level of rights tailoring is permissible. Each class of security may have different rights attaching to it (e.g., voting rights, the right to receive a dividend (fixed, subordinated, preferred), and the right to proceeds after the dissolution of a company (e.g., fixed, subordinated, preferred)).

The articles of association of a joint stock company may also provide for special conditions under which employees may acquire equity securities of the company.



## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

Czech law provides for a significant degree of flexibility in relation to the board constituency (i.e., number of directors, terms of office, qualified majority to pass a resolution, or substitute members voting). The shareholders generally constitute the board by voting at a general meeting.

### ‘Company body’ and ‘statutory body’

The term ‘company body’ or ‘corporate body’ is a general term that refers to organs of a company (such as directors, the board of directors, a statutory director, a supervisory board, a general shareholders’ meeting, and other voluntary committees of a company).

In the context of Czech company law, the term ‘statutory body’ is a general expression used for a company body that has generally unlimited power to represent the company *vis-à-vis* third parties and is registered in the Commercial Register in the entry regarding the authorized representatives (signatories) of the company.

### Limited liability company

A limited liability company has no board of directors; instead, the company is represented by one or more executives. The executives can, however, form a board if the constitutional documents of the limited liability company provide for this. A limited liability company may establish a supervisory board as a controlling body but the establishment of a supervisory board is not mandatory. As such, the governance structure of a limited liability company typically includes:

- (a) one or more directors that represent the company *vis-à-vis* third parties and exercise the day-to-day management of the company; and
- (b) a voluntary supervisory board that supervises the directors and examines whether they are complying with their duties and whether the company itself is properly managed.

A statutory body of a limited liability company is comprised of one or more directors. Each director may represent the company *vis-à-vis* third parties individually unless provided otherwise in the relevant constitutional document of the company.

### Joint stock company

A joint stock company may have either a one-tier or two-tier governance structure.

The one-tier structure is comprised of:

- (a) a statutory director (CEO) that represents the company *vis-à-vis* third parties and exercises the day-to-day management of the company; and
- (b) a board of directors that oversees the statutory director and decides the basic principles and goals of the management of the company which the statutory director must adhere to.

The two-tiered structure is comprised of:

- (a) a board of directors that represents the company *vis-à-vis* third parties and exercises the day-to-day management of the company; and
- (b) a supervisory board that supervises the board of directors and examines whether directors comply with their duties and whether the company itself is properly managed.

Unless the articles of association provide otherwise, the Business Corporation Act requires that the board of directors of a joint stock company is comprised of three directors. However, the articles of association may provide for the board to have fewer directors (but it must have at least one director)

or provide for the board to have more than three directors. The maximum number is not specified. If there is a tie, the vote of the chairman of the board is decisive unless otherwise provided for in the articles of association.

## Voting rights

Generally, a decision by the general meeting requires a majority of votes of the present shareholders. However, certain decisions (e.g., appointment of directors, investment decisions, approvals of dividends, increases of the registered capital, company restructurings and other related decisions) may require a qualified majority vote by operation of law or as prescribed in the articles of association. The qualified majority prescribed by the law is either a two-thirds or three-quarters majority of votes of shareholders present at the general meeting depending on the type of decisions. However, the articles of association may provide for a different qualified majority or require a unanimous decision for prescribed matters. If the law prescribes the qualified majority vote, the articles of association may only provide for the same or a higher majority vote. The articles of association may also provide for situations in which certain shareholders have additional votes or differential voting rights.

For voting outside the general meeting, the majority is calculated taking into account all votes of all shareholders.

## Approvals

Generally speaking, directors or managers are entitled to represent the target *vis-à-vis* third parties and these persons are authorized to act solely. Nevertheless, the articles of association may provide for joint representation by two or more directors.

In addition to those matters prescribed by law, the articles of association may provide for other matters that are subject to approval of the general meeting and/or supervisory board. These matters ought not to include day-to-day management of the target (which is entrusted to the directors and/or management).

In relation to both the limited liability company and the joint stock company, the general meeting of shareholders of the company (or a sole shareholder) is the highest company body that decides on the fundamental questions concerning the company. Furthermore, the articles of association may set up additional bodies of the company (e.g., various committees). However, these bodies cannot generally assume powers and duties that are exclusively granted to, or imposed on, the mandatory bodies of the company.

## Appointment and removal of directors

There are no residency requirements for directors of a Czech company. Directors are appointed and removed by a resolution of general meeting (if not provided for in the articles of association, the directors are appointed and removed by the supervisory board of a joint stock company), and once the appointment is made, the company must proceed with the filing with the relevant commercial register. In relation to the removal of directors and subject to the provisions of an agreement entered into between the relevant director and the company, the positions of directors can be terminated unilaterally by the relevant director or by the company without giving any reason. The shareholders agreement may provide for differential voting of shareholders in relation to the appointment or removal of directors.

## 13. What measures are commonly used to give a private equity fund some level of control over key operating and financial decisions made by a portfolio company?

The shareholders agreement typically includes mechanisms in relation to key operating and financial decisions. These mechanisms are also reflected in the articles of association of the target.



Control mechanisms may differ depending, among other things, on the number of shares held by the private equity investor. Special rights allowing control are granted to ‘qualified shareholders’ (i.e., those exceeding a given shareholding threshold in the registered share capital or voting rights of the company). Qualified shareholders may request directors to call a general meeting, add issues to the general meeting agenda, request the supervisory board to review conduct of the board of directors, etc. Furthermore, under certain conditions, qualified shareholders may bring a so-called shareholder action on behalf of the company against a director/member of a supervisory board/person exercising influence over the company in relation to their liability for damages, or against a shareholder that has not paid up their equity contribution. Moreover, qualified shareholders may request the court to appoint an expert to examine the report on the relationships between the controlling person and controlled persons.

The ability to control the operating and financial decisions of the portfolio company naturally depends on the share that the private equity fund has in the company (e.g., the ability to appoint/remove directors/other company bodies of the portfolio company). However, subject to the exception regarding specific information, all shareholders of a limited liability company have a right to information related to the company and all shareholders of a joint stock company have a right to an explanation of issues related to the company. The ability to control the operating and financial decision of the portfolio company is lower in the case of non-voting equity securities. The ‘exception regarding specific information’ refers to information that the shareholders of a limited liability company and shareholders of a joint stock company may not access. For both a limited liability company and a joint stock company, this means publicly available information or certain classified information. For a joint stock company, in addition, the company may refuse to provide an explanation/information if it might cause harm to the company or persons controlled by the company or if it concerns inside information.

#### 14. What employment terms are generally imposed on management in a buyout?

Czech law distinguishes between company managers and statutory bodies (directors). This is a key difference to be taken into account in relation to the management structuring purposes.

Managers are the company’s management employees. The relationship between a company and its managers is an employment relationship governed by an employment contract and the Czech Labor Code. The law offers a certain degree of flexibility in relation to the employment contract. However, rules in relation to the protection of employees must be complied with. Senior management members are typically appointed as the target company’s directors.

The relationship between a company and its directors (statutory body) however is a commercial relationship governed by an agreement negotiated between the director and the company. The law offers a significantly increased degree of flexibility in relation to this agreement in comparison with an employment contract. However, the agreement must be in writing, approved by the general meeting of the company, and specify in detail the remuneration scheme. If the remuneration issue is not reflected in the agreement, the director is not entitled to any remuneration. Furthermore, if the agreement or the clause relating to the remuneration is invalid due to an act of the company then the director is entitled to usual remuneration. The agreement may for example provide for the term of the appointment of the director.

Usually, the directors’ remuneration structure includes fixed remuneration and performance-related bonuses. In addition, directors may receive incentives, for example, in the form of shares or share options.

## 15. What equity incentives can be offered to management and how are they typically structured?

The most common incentives take the form of shares, share options, various cash bonuses and severance payments. Good leaver and bad leaver clauses in shareholders agreements are quite common. The employment contract between the managers (employees) and the company may contain non-compete clauses and these are enforceable.

## 16. How are buyouts typically debt financed and secured?

Transactions are typically financed by a combination of senior debt and equity. This is typically provided in the form of subordinated debt or by a so-called additional monetary contribution to the equity capital of the company. Subject to compliance with financial assistance rules, security is typically given by way of various share and asset pledges.

Under Czech law, all sorts of assets and property are pledged (e.g., ownership interests in limited liability companies, shares in joint stock companies, movables or real property). Individual categories of assets/property (e.g., shares, movables, real property, ownership interests) may be pledged under separate pledge agreements such as an agreement on pledge of shares, an agreement on pledge of movables, a mortgage agreement and an agreement on pledge of ownership interest.

In addition to pledges separately established over different categories of assets as explained above, a pledge over the enterprise of the company may be established as an ‘umbrella’ security covering all assets and property of that company, irrespective of whether or not they have already been separately pledged.

Certain security agreements may be subject to approval by the general meeting of the company.

## 17. Are there financial assistance issues to consider when undertaking a buyout?

Financial assistance in the Czech Republic is regulated in the Business Corporations Act that sets out the financial assistance rules for:

- (a) a limited liability company (*společnost s ručením omezeným*); and
- (b) a joint stock company (*akciová společnost*).

Under the Business Corporations Act, financial assistance may be provided only on the conditions set out below.

### Limited liability company

Unless the articles of association state otherwise, a limited liability company may provide financial assistance if:

- (a) the financial assistance is provided under fair trade conditions, particularly in relation to the interest charged and whether the security given by way of the financial assistance benefits the company; and
- (b) the executive prepares a written report in which he/she factually states the reasons for the provision of the financial assistance (including any advantages and risks to the company, specifications of the conditions under which the financial assistance is to be provided, and states reasons why the provision of the financial assistance is not in conflict with the interests of the company).



The company must file the report referred to in (b) above with the Collection of Deeds without undue delay after the general meeting has approved the financial assistance. The Collection of Deeds is an archive maintained by the register courts as a part of the Commercial Register. It contains corporate and financial documents relating to the incorporated company.

The report referred to in (b) above must also be made available to the participants at the registered office of the company from the date when the invitations to the general meeting have been sent and must be freely available at the general meeting.

### Joint stock company

The Business Corporations Act provides that financial assistance may be provided by a joint stock company, if permitted by its articles of association and subject to the following conditions:

- (a) financial assistance is provided under fair market conditions (particularly in relation to the interest charged) and provided the financial assistance benefits the company;
- (b) the board of directors verifies the financial capacity of the person/entity to whom/which the financial assistance is provided;
- (c) provision of the financial assistance is approved by the general meeting in advance based on a report by the board of directors as detailed in (d) below (adoption of the decision requires approval by at least two-thirds of the votes of shareholders who are present at the general meeting);
- (d) the board of directors prepares a written report in which it:
  - (i) states reasons for the provision of the financial assistance, including any advantages and risks to the company;
  - (ii) specifies the conditions under which the financial assistance is to be provided, including the price for which the recipient of the financial assistance is to acquire the shares;
  - (iii) states the results of the financial capacity verification;
  - (iv) states why the provision of the financial assistance is in the interests of the company; and
  - (v) states, if shares are acquired through financial assistance in the company providing the financial assistance, an adequate price for those shares;
- (e) provision of financial assistance does not cause any decrease in the equity below the limit of the subscribed registered capital increased by funds that cannot be divided among the shareholders under the Business Corporations Act or the articles of association, taking into account any decrease in equity which may occur if the company (or another entity on its behalf) acquires its shares; and
- (f) the company must create a special reserve fund in the amount of the provided financial assistance.

The company must file the relevant reports with the Collection of Deeds without any undue delay after the general meeting has approved the financial assistance. This report must be made available to the shareholders at the registered office of the company and posted on the company's website from the date of the general meeting at which the financial assistance is to be approved and be freely available to the shareholders at the general meeting.

Where financial assistance is to be provided to a member of the board of directors, a person controlling the company, a member of its statutory body, or a person acting in conjunction with the

company or with any of the above persons, or a person acting in its own name but in lieu of the above persons, a generally recognized expert independent of the company and these persons, as designated by the supervisory board, must review the reports referred to above. In his/her/its written report, the expert assesses the correctness of the written report by the board of directors and expressly comments on whether or not provision of the financial assistance is in conflict with the interests of the company.

These requirements in relation to the giving of financial assistance do not apply where employees are acquiring shares in the company nor where financial assistance is provided by banks and financial institutions, if that assistance is provided within the ordinary course of their principal business.

### Whitewash procedure

The relevant sections of the Business Corporations Act provide the minimum requirements for a ‘whitewash procedure’. However, the company’s constituent documents (i.e., the memorandum of association or articles of association) may provide for further, more restrictive, requirements.

As outlined above, if financial assistance is provided by a joint stock company the consent to that financial assistance must be given by the general meeting prior to the provision of the financial assistance. However, if the financial assistance is provided by a limited liability company, it is sufficient if the consent of the general meeting to that financial assistance is given after the provision of the financial assistance.

If financial assistance is provided without the required consent of the general meeting, provision of the financial assistance might be declared invalid, if challenged by a legitimate person within the period of six months after that person learned (or should and could have learned) of that invalidity, but in any event not later than ten years after the provision of the financial assistance.

## 18. What are the implications under the corporate benefit laws of the Czech Republic for a company providing financial assistance?

Financial assistance in the Czech Republic may be provided under fair trade conditions only, particularly in relation to the interest charged and whether the security provided in relation to the financial assistance benefits the company.

Also, the concept of ‘due managerial care’ of members of the board of directors of a company (and directors in the case of a limited liability company) applies under Czech law. Board members are obliged to perform their functions with the required loyalty, knowledge and care. It is assumed that one acts carefully and with the required knowledge if he/ she, when making a business decision in good faith, has acted in an informed manner and in the justifiable interests of the company (the so-called ‘business judgment rule’). There may be different interpretations of what is in the justifiable interests of a company, but the transaction should in any case at least be beneficial to the company and should serve the company’s interests.

Board members are liable for any damage they cause to the company if they neglect their duties. The burden is on board members to establish that they have acted with due managerial care. When assessing whether or not a member of the board of directors has acted with due managerial care, the particular actions of that board member will be compared to the care that would usually be taken by another reasonably acting person in the same situation and facing similar circumstances.

Moreover, there are specific provisions of the Business Corporations Act regulating abuse of influence or control. Under these provisions, anyone who makes use of his/her influence in a company to substantially influence the behavior of that company to its detriment is obliged to compensate the company for that detriment, unless the influencing individual shows that it has acted in an informed manner and in the best interests of the company.



By operation of law, the influencing individual is also responsible to the company's creditors for the proper fulfillment of the obligations of the company that the company was not able to fulfill (partially or in full) because it was influenced by the influencing individual.

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

Generally speaking, secured creditors (i.e., creditors of receivables which are secured with pledge, mortgage, assignment of receivables, retention right or security transfer of right) rank ahead of unsecured creditors. Secured creditors can be satisfied directly from the proceeds of sale of the relevant asset and at any time during insolvency proceedings.

Assets may generally be sold:

- (a) at a public auction with the sale being authorized by an auctioneer;
- (b) at a public auction supervised and authorized by a court; or
- (c) on the basis of a sales agreement between the insolvency trustee and the buyer which is authorized by the insolvency court and majority of creditors.

Additionally, there are other receivables that are given priority ranking (such as tax receivables, cost of administration of the insolvency proceedings, employee receivables). Other receivables may only be satisfied based on a final distribution plan, i.e., after the insolvency proceedings are completed.

Unsecured creditors rank ahead of shareholders (unless the shareholders are also secured or unsecured business creditors of the insolvent company). The business receivables of shareholders ought to be distinguished from the shareholders' liquidation balance share.

The creditors are satisfied in the following order of priorities:

- (a) secured creditors (satisfied directly from the proceeds of sale of the relevant asset);
- (b) tax receivables, cost of administration of the insolvency proceedings and employee receivables;
- (c) unsecured creditors on a *pro rata* basis (including secured creditors not fully satisfied from the sale of the asset encumbered by the security); and
- (d) receivables of shareholders of the company (satisfied by way of shareholders' liquidation balance share, if any).

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

There are several key tax and duty considerations that must be taken into account when undertaking a Czech buyout. These are set out below.

### Dividend payments/Withholding tax

Generally, dividends paid by a Czech entity in the form of a limited liability company or a joint stock company are subject to Czech withholding tax of 15%.

Nevertheless, if the parent company:

- (a) has the legal form of, for example, a Czech joint stock company, Czech limited liability company, European company, European cooperative society, and other legal forms of other member states of the European Union;

- (b) is a resident of a member state of the European Union;
- (c) is not exempt from corporate income tax and does not have an option for exemption; and
- (d) has held at least 10% of the registered capital of the Czech entity for a period of at least twelve months,

then the distributed dividends are exempt from withholding tax in the Czech Republic.

The parent company may also be able to benefit from the relief provided by a relevant international tax treaty.

## Exit

As a general rule, the capital gain realized by a Czech non-resident on the sale of Czech shares or participations is subject to Czech corporate income tax.

This taxation may be subject to relief under a particular tax treaty. Most of the tax treaties that the Czech Republic has entered into provide for full relief, unless the seller has a permanent establishment in the Czech Republic.

For a parent company residing in a member state of the European Union, the capital gain is exempt under conditions similar to the conditions for dividend withholding exemption (see above).

## Interest from the acquisition credit facility

Generally, interest from an acquisition loan taken for the purposes of the purchase of shares of the portfolio company is not tax-deductible. Various debt-push-down structures need to be employed to achieve tax-deductibility.

On the other hand, interest from a loan taken to fund the purchase of assets of the portfolio company (purchase of the enterprise or a part of the enterprise or purchase of individual assets) is generally tax-deductible.

## Depreciation and amortization

Influence of the buyout on the amount of depreciation and amortization of the tangible and intangible assets of the target also ought to be taken into account. When structuring the buyout as an asset deal, tangible and intangible assets of the target may generally be re-evaluated under certain conditions. On the other hand, when structuring the deal in other ways, re-evaluation may not be permitted by law.

## Real estate

The real estate tax issues ought to be considered when structuring the transaction. When structuring the buyout as an asset deal, the real estate transfer is generally subject to a real estate transfer tax. The general real estate transfer tax rate amounts to 4% of the purchase price of the real estate. However, there are certain exemptions to this tax, in particular, in relation to the first acquisition of specified types of property against payment, acquisition of specified flats and premises, or a specific case during insolvency proceedings.

## VAT

If the transaction is structured as a sale of an enterprise or a part of an enterprise, no Czech VAT is chargeable. If the transaction is structured as a sale of individual assets, Czech VAT is chargeable.

A transfer of shares is generally not subject to VAT in the Czech Republic.

Therefore, whether both parties are registered for the VAT purposes ought to be taken into account in various deal structures so that they may fulfill their potential VAT duties as specified above.



## Thin capitalization rules

According to the thin capitalization rules under Czech tax law, financing costs (including interest and other related expenses) in respect of credits and loans provided by related parties in excess of the ratio 4:1 between the aggregate value of related party debt and equity of the company are tax not deductible. The ratio for banks and insurance companies is 6:1. The thin capitalization rules also apply to back-to-back financing (i.e., to financing costs with regard to credits and loans between related parties arranged through an unrelated third-party intermediary, such as a bank). Financial costs paid on profit-participating credits and loans are fully tax non-deductible.

Unrelated party loans (e.g., bank loans) are not subject to the thin capitalization rules.

The tax deductibility test applies to interest as well as to other financial costs on loans (i.e., interest plus other related costs such as fees, etc.).

## 21. What forms of exit are available?

Generally, all forms of exits are allowed under Czech law, including share deals and various forms of asset deals (e.g., purchase/sale of an enterprise of a company or a part of a company).

Also, various merger structures can be used as follows:

- (a) one or more companies cease to exist and merge with another existing company which is the successor company that acquires the enterprise of the dissolved company/companies;
- (b) two or more companies cease to exist and constitute a new successor company that acquires the enterprises of the dissolved companies;
- (c) division of a company resulting in the dissolution of the company where the respective parts of the divided company may either constitute a new company or merge with another existing company and the original company ceases to exist;
- (d) division of a part or parts of a company where the respective parts of the divided company may either constitute a new company or merge with another existing company and the original company continues to exist; or
- (e) transfer of an enterprise to a shareholder.

The law also provides for cross border mergers.

IPOs are not very common in the Czech Republic.

## France

### 1. What structures do private equity funds typically use to manage their funds?

The typical fund structures used in France are *Fonds Commun de Placement à Risque* (**FCPR**) and *Fonds Professionnel de Capital Investissement* (**FPCI**). While FCPRs are retail funds open to all investors, FPCIs are funds reserved to professional clients within the meaning of the Markets in Financial Instruments Directive 2004/39/EC and clients whose initial subscription is above EUR 100,000 (**MiFID**).

Both the FCPR and the FPCI are co-ownerships of securities without separate legal personality that are transparent for French tax purposes and qualify as alternative investment funds (AIF) under the Alternative Investment Fund Managers Directive 2011/61/EU (**AIFMD**).

FCPRs and FPCIs are set up jointly by:

- (a) a French portfolio management company licensed by the French Market Authority (*Autorités des marchés financiers*) (**AMF**) or an EU alternative investment fund manager (**AIFM**) acting under the AIFMD management passport; and
- (b) a French depositary.

FCPRs and FPCIs must satisfy certain investment quotas depending on the nature of the assets. For example at least 50% of the assets of an FCPR and an FPCI must consist of:

- (a) quasi-equity or equity securities of companies or securities giving access to equity of companies, which are not traded on a French or foreign financial instruments market;
- (b) quasi-equity or equity securities of companies or securities giving access to equity of companies, traded on a French or foreign financial instruments market (such as Euronext Paris or Alternext Paris), provided that the market capitalization of the company is below EUR 150 million and within the limit of 20% of the fund's assets; or
- (c) shares in limited liabilities companies (*sociétés à responsabilité limitée*) (**SARL**) or companies of an equivalent status in their country of residence that are not listed.

French law provides that the investors in an FCPR and an FPCI are not liable for the debts and obligations of the fund beyond the amount of their commitments.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in the jurisdiction?

#### FCPRs

FCPRs are subject to prior approval from the AMF. The standard review period by the AMF is one month. No marketing can take place in France until the vehicle has been approved by the AMF.

#### FPCIs

FPCIs are exempt from any prior approval requirement. A mere filing of the FPCI rules with the AMF within one month of the fund's first closing is required.

#### Fund managers

Both FCPRs and FPCIs must be managed by:

- (a) a French entity licensed as a portfolio management company by the AMF; or



- (b) an EU-AIFM acting under the AIFMD management passport (either on a cross-border basis or by the establishment of a French branch).

Portfolio management companies above the AIFMD EUR 100 million/EUR 500 million thresholds<sup>9</sup> must comply with all authorization requirements set out by the AIFMD, in particular, regarding regulatory capital, organizational structure, valuation, remuneration, reporting, risk management, internal control, delegation and liquidity management, conflicts of interest and depositary.

Small portfolio management companies with assets under the AIFMD EUR 100 million/EUR 500 million thresholds are subject to a slightly more flexible regime. Lesser requirements are applicable in relation to the minimum level of own funds required under the AIFMD regulation, reporting and leverage, valuation, remuneration, delegation and liquidity management. In contrast with the registration regime set out by the AIFMD, French small portfolio management companies must be fully licensed by the AMF and are subject to most AIFMD requirements applicable to companies above the EUR 100 million/ EUR 500 million thresholds regarding regulatory capital, organizational structure, risk management, internal control, conflicts of interest and depositary under French law.

### 3. Are there any approvals required for investments by foreigners in the jurisdiction and, if so, what is the process?

In principle, foreign investments are not restricted in France and are generally only subject to a declaration on completion (rather than prior authorization) with the exception of operations taking place in any sector of activity in which state-control remains effective (set out below).

#### Prior authorization

The prior authorization of the Treasury Department of the Ministry of Economy (*Ministère de l'économie et des finances*) (**Ministry of Economy**) must be obtained for investments in any activity pertaining to the exercise of public authority in France such as:

- (a) activities likely to jeopardize public order, public safety or national defense interests; or
- (b) research in, manufacture or marketing of, arms or weapons, munitions, or explosives.

In addition to defense sector activities, activities in relation to gambling (other than casino business), private security, security of information technology systems and products, cryptology products and services and double-use (civil and military) products or technologies, as well as other activities performed by companies holding national defence secrets, must also be pre-notified and prior authorized by the Ministry of Economy.

Other activities considered necessary to matters of public security or national defense are also in the sectors listed below are also requiring special treatment by pre-notification and prior authorization by the Ministry of Economy since 2014:

- (a) provision of electricity, gas, hydrocarbons or other sources of energy;
- (b) provision of water;
- (c) operation of transportation networks and services;
- (d) operation of electronic communications networks and services;
- (e) operation of an establishment that is strategic to French national defense; and

<sup>9</sup> EUR 100 million of assets under management, or EUR 500 million of assets under management, where the fund does not use leverage and its investors have no redemption rights exercisable for a period of five years following the date of the initial investment in the fund.

- (f) protection of public health.

For those specific sensitive activities, the acquisition by a foreign investor of a direct or indirect controlling interest (or, for non EU and non EEA investors, crossing the threshold of 33.33% interest) in a company having its registered office in France or of a business located in France, requires the prior authorization of the Ministry of Economy under the Monetary and Financial Code (which also distinguishes non-EU investors, who are subject to a stricter regime than EU investors).

#### *Authorization process*

The Ministry of Economy has two months from the date of notification of a complete application to grant or deny its approval. If it makes no decision by that deadline, authorization will be deemed to be granted. Authorization is also deemed to be granted if the investment is between companies belonging to the same group (i.e., companies in which more than 50% of the share capital or voting rights are held directly or indirectly by the same shareholder), unless the objective of the investment is to transfer all or part of a line of business out of France.

The Ministry of Economy may grant its authorization subject to conditions (to ensure the investment will not negatively impact national interests). These conditions generally cover:

- (a) requesting a guarantee from the investor that it will ensure the proposed activities are pursued in such a way so as to preserve industrial capacity and the research and development potential and know-how of the shareholders of the French target company guaranteeing the adequacy of supply; and/or
- (b) ensuring the French target company will still be able to fulfill its contractual obligations, either as party or sub-contractor to a government contract, or, more generally, any contract related to security, national defense, research, manufacture or sale of weapons, munitions, powder or other explosives.

#### *Failure to obtain authorization*

If the activity is merely ancillary to the other activities of the French company, the Ministry of Economy may make authorization conditional on the transfer of the ancillary activity to an independent third party.

The Ministry of Economy may refuse to grant authorization, where:

- (a) there is a significant risk that the investor will commit an offense; or
- (b) the implementation of the conditions mentioned above would not be sufficient to preserve France's national interests because it would appear that:
  - (i) the continuation of the activities, industrial capacities, and research and development of the industrial entities or of the shareholders' know-how would not be preserved;
  - (ii) the adequacy of supply would not be guaranteed; or
  - (iii) the performance of contractual obligations would be compromised.

If the investor fails to request prior authorization from the Ministry of Economy, or proceeds with its investment despite a refusal from the Ministry of Economy, or fails to comply with the conditions set out by the Ministry of Economy, the latter may issue an injunctive order ordering that the investor:

- (a) reinstates the *status quo*;
- (b) discontinues the investment; or
- (c) modifies certain details of the conditions of the investment.



If an investor fails to comply with that injunction, it may face a fine in the amount of twice the amount of the illegal investment, and the validity of the investment and of all ancillary actions or agreements may be challenged.

At the very beginning of the process, it may be advisable for investors to directly seek advice from the Ministry of Economy about whether the investment falls within the scope of activities subject to prior authorization. The Ministry of Economy will have two months to respond to any preliminary inquiry. If it does not respond during that period, the investor is not permitted to assume it needs no prior authorization; the investor should assume that prior authorization is needed and will need to submit a complete application for authorization. Prior authorization is deemed to have been obtained two months after receipt by the Treasury Department of a complete application for authorization unless a decision to decline authorization for the transaction is notified to the applicant within that two-month period.

#### *Declarations to the Ministry of Economy*

Certain transactions need only require a ‘declaration’ to the Treasury Department of the Ministry of Economy (rather than an application for prior authorization). The following transactions fall within this category:

- (a) incorporation of a French company by a foreign company or a non-resident individual;
- (b) acquisition of all or part of a line of business of a French company by a foreign company or a non-resident individual; or
- (c) real estate acquisitions executed by foreign investors in France if the amount of the operation exceeds EUR 1.5 million.

The declaration must be addressed to the Ministry of Economy on the date of completion of the investment. This is usually the date of execution of a binding agreement, publication of the bid or exchange offer or when an asset is actually acquired. The date of the first of these determines the date on which the declaration is due.

Generally, foreign investors divesting their French investments must also file a reporting declaration with the Ministry of Economy.

#### **Exchange controls**

In addition, French law requires that foreign investors notify the French National Bank (*Banque de France*) of any transactions the amount of which is greater than EUR 15 million and as a result of which the foreign investor acquires an interest representing at least 10% of the share capital of a French company or crosses a threshold of 10% of the share capital. These notifications must be filed within 20 business days after the completion of the transaction.

#### **4. Who are the relevant regulators in the jurisdiction and how much interaction would one generally expect when undertaking a buyout?**

The primary regulatory authorities in France in a corporate context are:

- (a) the French Market Authority (*Autorités des marchés financiers*) (**AMF**) – the primary regulator of financial services and listed companies;
- (b) the French National Bank (*Banque de France*);
- (c) the Competition Authority (*Autorité de la Concurrence*) – the French competition/antitrust regulator;

- (d) the Ministry of Economy (*Ministère de l'économie et des finances*) (**Ministry of Economy**) – in charge of monitoring foreign investments; and
- (e) the tax administration.

Interaction with regulatory authorities largely depends on the nature of the transaction and the parties involved (e.g., whether the buyout involves competition/antitrust issues, whether the acquirer is a foreign party and whether the parties concerned or the transaction require prior approval/notification as described in the answer to question 3).

## 5. How are buyouts typically undertaken in the private and the public markets?

### Private context

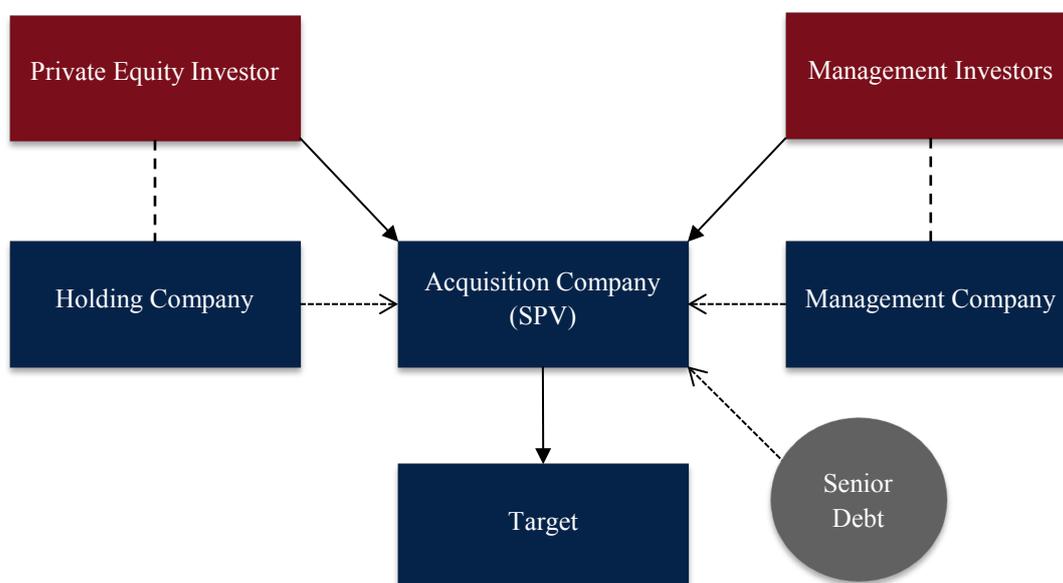
In a private context, transactions are usually undertaken by way of negotiated acquisition. That is, negotiated sale and purchase documents are prepared, negotiated and executed and those documents record the terms of the sale and acquisition and the rights and liabilities of the parties.

### Public context

In a public context, buyouts are generally concluded by way of a takeover bid or acquisition of a controlling block of shares. A bidder can squeeze-out minority shareholders and delist a target company listed on Euronext Paris or Alternext Paris provided that it holds, alone or acting in concert, more than 95% of the shares and voting rights of the target company.

## 6. What is the typical corporate structure used when doing a buyout?

Acquisition structures do vary from transaction to transaction, depending in particular on the tax jurisdictions and constraints of the investors and the requirements of the lenders. However, a standard investment structure would at least involve an acquiring company (**Acquisition Company**) incorporated as a special purpose vehicle for the buyout transaction, in which the private equity investor and the management investors invest, directly or indirectly (respectively via one or several holding companies and management companies), along the following lines:



The *Société par actions simplifiée* (**SAS**) and the *Société Anonyme* (**SA**) are the most common forms of limited liability company used in France for the Acquisition Company for buyout transactions.



However, because of the advantages of the SAS compared to the SA as further described below, the SAS is more commonly used than the SA.

## SAS

The SAS is the corporate structure most commonly used by foreign investors in France in particular because it can be wholly-owned and is very flexible in terms of the organization of its management structure and its shareholder relationships. The share capital of an SAS is split up into shares (*actions*) and the shareholders may be French or foreign individuals or legal entities. No minimum share capital is required for an SAS. The shareholders' liability for the debts and obligations of the SAS is limited to the amount of their capital contributions.

The SAS is the most commonly used acquisition vehicle used in buyout transactions as its legal and operating structure, notably its management, is particularly adaptable and flexible, especially when compared to the other limited liability legal structures available in France (such as the SA or the *société à responsabilité limitée (SARL)*, both of which are more strictly regulated).

The SAS is loosely regulated by a small number of provisions of the French Commercial Code (*Code de Commerce*) (**Commercial Code**). These provisions include concise rules relating to management and shareholder decisions, leaving most of the responsibility for organizing corporate matters in the company's articles of association. In contrast with the SA, the principal characteristic of the SAS is the freedom its shareholders have to organize in the articles of association the corporate governance rules, and in particular to determine voting majorities or quorum requirements, as well as the allocation of powers between the shareholders and the management of the company.

Another advantage of the SAS is the ability to include specific clauses in the articles of association aimed at regulating shareholder relations, therefore stabilizing the control of the company. The SAS is also less regulated than the SA in terms of share transfer restrictions, clauses allowing a shareholder to be excluded from the share capital and standstill provisions. Contrary to similar provisions in a shareholders agreement, these clauses, if provided for in the articles of association, are binding on, and enforceable against, third parties.

One of the disadvantages of the SAS is that it cannot be listed on the stock exchange. Therefore, an SAS must be converted into an SA before any listing.

## SA

The share capital of an SA is also divided into shares (*actions*). An SA must have at least seven shareholders (French or foreign individuals and/or legal entities). If the number of shareholders falls below seven, any interested party may request that the Commercial Court (CC) dissolves the company at the expiry of a one-year period counting from the date on which the number of shareholders fell below seven. However:

- (a) it is possible to request the CC to grant a six month extension to allow the company to fix the number of shareholders; and
- (b) the company's dissolution cannot be governed by the CC if the situation materializes on the day the court makes its ruling.

The share capital must be at least EUR 37,000 (or for listed SAs, EUR 225,000). Shareholders' liability for the debts and obligations of the SA is limited to the amount of their capital contributions (i.e., they are generally not liable beyond their shareholding).

Unlike the SAS, the SA is strictly regulated. Majority and quorum requirements and the allocation of powers between management and shareholders are a legal requirement and can only be modified in a limited fashion and/or subject to stringent conditions. However, an SA may be listed on the stock exchange. Therefore, the SA is sometimes used in buyout transactions.

## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

#### *Private context*

For a buyout negotiated in a private context the primary legal document that records the transaction is the sale and purchase agreement. A shareholders agreement is also entered into between the investors and the members of the management team who become shareholders of the Acquisition Company.

There may also be other ancillary transaction documents prepared depending on the nature of the deal. These can include a separate representations and warranties agreement (if the representations and warranties are not provided for in the sale and purchase agreement) and a transition/shared services agreement.

#### *Public context*

For a buyout in a public context the documentation to be prepared depends on whether the transaction is undertaken as a voluntary takeover bid or, more commonly, as the acquisition of a controlling block of shares followed by a mandatory takeover bid.

When there is an acquisition of a block of shares, the primary document negotiated between the bidder and the main shareholder(s) of the target is a sale and purchase agreement. This records the agreement of the parties in relation to the acquisition of the block of shares and the terms on which they have agreed to do so (including any conditionality and representations and warranties). Any block transaction as a result of which the bidder crosses the thresholds of 5%, 10%, 15%, 20%, 25%, 30%, 33,1/3%, 50%, 66,2/3%, 90% and 95% of the share capital or voting rights of a French public company must be reported both to the AMF and to the company within four trading days.

In the case of a voluntary takeover bid, the primary document for the bidder is an offer document (*note d'information*). This will include certain prescribed disclosures, together with the terms of the offer by the bidder. Prior to the filing of the offer document, the bidder, the target company (and in some cases its major shareholders) may, where appropriate, enter into an agreement governing the conduct of the voluntary takeover bid, the governance of the combined business after the completion of the transaction and, even, the acquisition by the bidder of the interests of the major shareholders as part of, or outside, the takeover bid procedure.

### Banking

The main banking document is the senior facilities agreement under which the senior debt facilities are documented, typically amortizing and non-amortizing term loans with working capital lines, and in some instances capital expenditure or acquisition facilities.

If there is mezzanine financing in addition to the senior facilities, there is typically a separate bonds issue agreement together with specific terms and conditions applicable to those bonds or a separate facility agreement if mezzanine loans are made available (which is however not common on the French market where mezzanine financing is typically made via bonds issues).

Bonds financing has become more common in the French market and these financings are documented with bond issue documentation.

In addition, if there are multiple injections of debt from various sources, the senior lenders and all other creditors party to the transaction enter into an intercreditor and subordination agreement to record the respective rights of the private equity investors, the management investors, the senior and mezzanine lenders/bondholders and hedging banks.



Creating security over French assets requires the negotiation of specific security documents governed by French law. The collateral benefits all financing parties, represented for the purpose of this security, by a security agent (via an agency clause which is typically provided for in the intercreditor and subordination agreement).

## 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

### Private context

In a private context, buyer protections usually take the form of negotiated representations and warranties from the seller (being either the shareholder(s) in a share sale or the company from which the business and assets are being acquired). The terms of that coverage vary from transaction to transaction, however, it is quite normal to expect that limits will be placed on this type of coverage, including claim thresholds and caps, time limits and adjustments for items otherwise disclosed or accounted for. Buyers sometimes require sellers to place a portion of the sale proceeds in escrow for a limited period of time or to provide a bank guarantee to secure the seller's indemnity obligations.

Sellers' representations and warranties and related indemnity mechanisms tend to be much more limited in the context of secondary buyouts. However, more extensive representations and warranties can be sought if a warranty and indemnity insurance policy is put in place (usually by the purchaser) because it is usually a condition of the insurance company for providing warranty and indemnity coverage. This type of insurance is however not yet broadly used on the French market even if it is seen in some buyout transactions.

### Public context

In a public context, the level of buyer protection which can be obtained is less than in a private context. The primary form of protection usually takes the form of conditions precedent to the acquisition (that either need to be satisfied or not triggered). Representations and warranties protection from target shareholders in a public company acquisition is usually limited and generally only extends to confirmation regarding unencumbered title and due authority to sell.

## 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

There are no specific laws regulating how conflicts are managed in a management buyout. However, the rules generally applicable in France in relation to corporate governance and corporate rules guiding the behavior of directors and officers do address conflicts as set out below.

### Interested party transactions

Transactions for example between a company and its directors, officers and certain shareholders, whether directly or indirectly (including transactions between unrelated companies having common directors and officers) may require board or shareholders' approval, depending on the form of the company. In an SA, the interested directors and shareholders are not excluded from the meetings of the board or of the shareholders voting in relation to the relevant transaction, but they cannot vote on the specific matter in relation to which they have an interest. Their shares are also not taken into account for the purposes of determining a quorum and a majority.

### Loans and guarantees

There are restrictions on the ability of companies to lend to, borrow from, or guarantee the commitments of, their directors and officers.

## Abuse by a majority

There are restrictions on resolutions that may constitute an abuse by a majority shareholder of its majority rights.

## General and fiduciary obligations

There are general statutory obligations on directors and officers of a corporation not to:

- (a) misuse their positions to advantage themselves (either directly or indirectly);
- (b) improperly use information of the corporation for their own benefit (this latter point being more relevant for listed corporations rather than for privately-owned corporations); and
- (c) breach their general fiduciary obligations as directors and officers of the company.

## 10. How are the equity arrangements typically regulated in a buyout?

The equity arrangements in a typical buyout are regulated primarily by a shareholders agreement entered into by the Acquisition Company (or a holding company sitting above the Acquisition Company), the fund or funds providing the equity, the managers invited to invest in the Acquisition Company/holding company alongside the private equity investor(s) and any existing shareholders who are retaining an interest in the target following the buyout. Additionally, the relevant company's articles of association typically include specific share rights attaching to different classes of shares to be issued.

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

In addition to common shares which grant to their holders basic shareholders' rights such as minimum information rights, rights to attend and vote at shareholders' meetings, the right to dividend distributions and other minimum protection rights provided by law or by the articles of association, private equity funds may use preferred shares.

A great amount of flexibility exists in relation to the types of rights that can be attached to preferred shares. The Commercial Code provides that preferred shares may be issued with or without voting rights and with specific rights of any nature, temporary or permanent. As a result, 'political' rights (e.g., voting rights, the right to information, the right to appoint or to a seat in the corporate governance bodies of the company) as well as financial rights (e.g., preferential right to dividends or to the liquidation proceeds of the company) can be tailored for preferred shareholders. Preferred shares can be redeemed.

Preferred shares must, however, comply with the following basic principles:

- (a) the categories of shares created and the rights attached to the preferred shares must be set out in detail in the articles of association of the company;
- (b) preferred shares can bear a fixed interest coupon or preferential rights to dividends, but the coupon or preferential rights can only be granted if and to the extent there are distributable profits available in the company (based on the previous fiscal year end profit plus distributable reserves);
- (c) preferred shares cannot bear multiple voting rights (only double voting rights);
- (d) preferred shares with no voting rights cannot represent more than half of the share capital of private companies, or more than one third of the share capital in public companies (however, there is more flexibility in the SAS than in the SA to 'tailor' the voting rights attached to preferred shares); and



- (e) a special independent appraiser must be appointed by the shareholders to prepare a special report describing and assessing each preferential right attached to the shares being issued.

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

The laws in relation to board constituency, appointment and removal and rights of the director of a company depend on the type of company (i.e., SA or SAS).

### SA

SAs are managed either by a general manager (*directeur général*) and a board of directors (*conseil d'administration*) or by a management board (*directoire*) under the control of a supervisory board (*conseil de surveillance*). The former is more common. An SA with a board of directors must have between three and 18 directors (the authorized maximum may be higher for mergers).

### SAS

The only required body is the chairman (president) who can be either a legal entity or an individual. The chairman need not be a shareholder. The bylaws may provide for the appointment of one or several general managers, who may be entrusted with the same authority and powers as that of the chairman to act in the name and on behalf of the company *vis-à-vis* third parties.

In general, preferred shares (of an SAS or SA) can grant their holders specific rights in relation to board composition and differential director voting rights, such as the right to appoint a certain number of directors or a veto right in relation to certain decisions. If no preferred shares are issued, this type of specific right can also be provided for in a shareholders agreement, the main difference being that the provisions of the shareholders agreement are not binding on, and enforceable against, third parties but only among the shareholders which are a party to the agreement.

## 13. What measures are commonly used to give a private equity fund some level of control over key operating and financial decisions made by a portfolio company?

The shareholders agreement typically includes:

- (a) the right to appoint one or more directors to the board of the portfolio company;
- (b) certain rights to receive financial and operating information in relation to the portfolio company on a regular basis;
- (c) a right to conduct an audit in relation to the portfolio company on a regular basis; and
- (d) specific prior consent or veto rights in relation to particular decisions of the portfolio company, including decisions that relate to operating or financial matters.

## 14. What employment terms are generally imposed on management in a buyout?

The members of a management team in a buyout are generally employees of the target company and/or a portfolio company. However, key members of management may also be officers of the Acquisition Company and/or the target company and/or the portfolio companies.

The employment agreements are generally for an unlimited period of time and the key managers are generally appointed as officers for a fixed period of time (but can also be appointed for an unlimited period of time in which case they may be removed from office at any time without cause nor severance payment).

It is also common for remuneration under these agreements to include a fixed component and a bonus component referable to performance (usually based on EBITDA targets). They also usually include severance pay in certain circumstances.

Equity incentives offered to management are almost invariably provided in a management equity term sheet, the terms of which are then included in the shareholders agreement and other ancillary agreements or documents. The details typically include the terms and conditions of the equity or quasi-equity instruments issued to management as well as good and bad leaver provisions and put and call option agreements.

## 15. What equity incentives can be offered to management and how are they typically structured?

Managers can be offered incentives through direct acquisition or subscription of shares in the Acquisition Company or holding company (whether ordinary shares or preferred shares), call options, acquisition of warrants to acquire shares on exercise and payment of an exercise price (*bons de souscription d'actions*) (**BSA**), stock options, shares granted for no consideration and other types of equity or quasi-equity instruments such as convertible bonds.

### Shares and BSA

Acquisition or subscription of shares or BSA requires a direct investment of the managers. As a shareholder, the manager will be taxed on capital gain on the sale of the equity. The managers are usually offered the opportunity to sell their shares or warrants on an exit or if there are other liquidity events or there is a termination, and generally enter into a put and call agreement with the issuing company or the private equity investor depending on the type of equity incentive instrument concerned.

To confirm the capital gain tax treatment in France, it is necessary for the acquisition or subscription price of the shares or BSA to be the fair market value, and that this value be documented in a report prepared by a third party expert, using a combination of various valuation methodologies. The manager will be at risk in relation to his investment and the conditions of exit must therefore reflect that risk. This means that the manager may potentially lose all or part of the invested amount in certain events and suffer capital losses. The investment must be fully financed at the time of the acquisition of the shares or BSA and with the manager's own financing resources (i.e. no loan granted by the issuing entity or by the private equity investor).

Management packages are heavily scrutinized by the French tax authorities in order to challenge the capital gain tax treatment and then characterize the gain as salary (which is a category of revenue subject to higher taxation). The Ministry of Economy has recently published a list of schemes that it considers to be problematic, which includes management packages using shares or BSA with preferential acquisition or selling conditions and whose sale conditions are based on the return of the invested amount, if the risk taken by the manager is deemed not sufficient.

### Stock options

Stock options are subject to specific rules under corporate law and can benefit from a specific tax and social security regime if the options are granted in compliance with certain rules of the Commercial Code and specific tax reporting requirements. Stock options are exercised at a strike price determined at the time of the grant and which must be the fair market value of the shares for a private company. Stock options are generally subject to vesting conditions (e.g., the continuous employment of the manager and/or the company's performance criteria).

The gain realized on exercise of the stock options by the manager (which is the difference between the market value of the shares at exercise of the options and the exercise price paid by the optionee



**(Exercise Gain)**), is not subject to any tax or contributions until the shares are sold. On the sale of the shares, the Exercise Gain is subject to tax and to specific social insurance contributions for the employee. Rates of social contributions and tax depend on the date of the grant of the options, the amount of the Exercise Gain and how long the shares acquired are held prior to the sale.

For the employer, a specific social insurance contribution is due at the time of the grant of the options and assessed on 25% of the value of the shares underlying the options, or 100% of their IFRS value. Then at the time of exercise of the options, the employer is not subject to any further contributions.

### Grant of shares for no consideration

A grant of shares to employees for zero consideration is also a form of employee equity incentive used in France. Currently, the law provides that the vesting of the award occurs on a date that is a minimum two-year period from the grant date, and once vested the employee becomes a shareholder of the company. Vesting can also be subject to the employee concerned being an employee of the company for a minimum continued period of time and meeting specified performance criteria.

An additional two-year holding period of the shares after the vesting is required to benefit from the specific tax and social security treatment in France. As long as the minimum two-year vesting and two-year holding periods are satisfied, the value of the shares delivered for no consideration is not taxed until the sale of the shares. On the sale of the shares, the gain at vesting, which is the value of the shares on the date of vesting, is not subject to standard social security contributions which are usually due on employment income. This vesting gain is, however, subject to specific social contributions for the employee due on share awards and subject to tax. The rates of the social contributions and tax depend on the date of the grant of the shares. For the employer of the beneficiary, a specific social insurance contribution at a rate of 10% is due at the time of the grant of the share awards but then at the time of vesting of the shares, the employer is not subject to any further social insurance contributions. Note that a reform of the legal, tax and social treatment of the employee share scheme is currently expected during 2015 and may create much more attractive conditions.

Grants of options and shares made under other conditions than those described above are taxed as a benefit-in-kind and are subject to social insurance contributions due both by the employee and the employer.

## 16. How are buyouts typically debt financed and secured?

### Senior debt

The most common financing structure always involves senior debt via bank loans. The acquisition financing may also include an additional layer of more junior debt and, in that case, it is then typically set up in the form of a mezzanine financing via a bonds issue subscribed to by mezzanine investors.

The senior lenders make the acquisition financing directly available to the Acquisition Company. Depending on the amount of liquidity in the market and the general standing of the Acquisition Company, financing may be granted on a 'certain funds' basis.

Beyond purely financing discussions (pricing, amount, term and duration) and key structuring issues (certain funds financing, margin ratchet, equity cure, terms of the syndication and underwriting etc.) the negotiations typically focus on the representations and warranties, the undertakings, the financial covenants and the events of default. The senior debt is usually made up of an acquisition financing tranche (used to complete the buyout) and other tranche(s) dedicated to the refinancing of the target group's indebtedness and/or the revolving financing of the general working capital needs and capex of the target group. These additional tranches may be made available directly to the target and target group members.

## Mezzanine financing

Mezzanine financing via a bonds issue may also be resorted to, as an additional layer of debt coming in addition to the senior debt. This mezzanine financing is generally made available directly to the Acquisition Company (which is then the issuer of the mezzanine bonds, generally subscribed to by private debt funds) and is exclusively used to finance the acquisition. In some cases, however, the mezzanine financing may be made available at the level of the immediate holding company of the Acquiring Company (in order to have a structural subordination of the mezzanine financing to the senior financing). The terms of the mezzanine financing would typically be synchronized with the terms applying to the senior debt. The mezzanine debt would be fully subordinated to the senior banking debt and the higher risk profile of the mezzanine financing is compensated by higher remuneration paid to the bondholders (which are typically private debt funds).

## High yield bonds and Unitranche financings

In addition to the classic senior and mezzanine structure described above, there is a trend in the French market towards 100% bond leveraged financing structured either as a unitranche financing made available by private debt funds or, for upper mid and large cap transactions, a U.S. law high yield bond financing. Depending on the transaction to be financed, these bonds financings are generally set up together with a revolving credit financing arranged by banks and dedicated to finance the general corporate purposes of the target group.

## Security

The types of security interests typically granted are:

- (a) share pledges; and
- (b) bank account pledges.

The security package may be extended to also include a pledge over:

- (a) receivables;
- (b) the on-going business;
- (c) inventory; and
- (d) intellectual property rights.

In each case, these pledges are usually provided under specific separate security documents.

Note that mortgages over real estate property are often used in the context of real estate private equity transactions (but rarely in the context of an acquisition which is not oriented towards real estate (mainly due to the high notarial costs and taxes linked to the creation of this type of mortgage)).

In the view notably to reinforce the banks' rights in term of security enforcement, a trend in the French market is to set up 'double Luxco' structures, mainly for the financing of upper mid cap/large cap buyouts. The purpose of this kind of structure, which is for the protection of the banks, is primarily to prevent the risk of hostile safeguard action being taken by the Acquisition Company and its sponsors/shareholders (hostile safeguard action is when a solvent French company that is in serious financial difficulty unilaterally applies for safeguard proceedings, the effect of this being that the banks cannot enforce their security until the completion of the safeguard process that may take between six and 18 months and are invited to enter into discussions with the French company and its sponsors/shareholders for the purpose of restructuring the debt). The interposing of two Luxembourg companies in the buyout structure allows the banks to enforce their rights under the Luxembourg law share pledges created at the level of the Luxcos notwithstanding the safeguard proceedings. However,



the cost and complexity of these structures and the increase of liquidity in the banking and bonds financing markets tend to limit the implementation of these structures.

There is no French law mechanism creating a security interest over the whole of the assets of a company such as a UCC filing in the U.S. or a floating charge in the UK and specific fixed charges on each kind of assets must generally be taken. Also, almost no mechanism for the assignment of an asset for security purposes exists under French law and it is not possible under French law to create a security on, or assign for security purpose, contracts and contractual rights.

Finally, the granting of guarantees or securities by target group companies is materially limited due to corporate benefit and financial assistance issues under French law and in practice, for securing the acquisition financing, only the assets of the acquiring company (i.e., mainly the shares of the target company) will be available for security (see the answers to questions 17 and 18).

## 17. Are there financial assistance issues to consider when undertaking a buyout?

The term ‘financial assistance’ refers to any advance of funds, any granting of loans and/or any granting of security interests and personal guarantees.

### Strict prohibition

French law provides for a very strict prohibition against financial assistance being provided by a stock company (*société par actions*) for the purchase of its own shares. Article L. 225-216 of the Commercial Code unequivocally states that:

‘A company shall not advance funds, grant loans or grant security interests with the view to enable the subscription or purchase of its own shares by a third-party’.

The prohibition against the giving of financial assistance applies to the direct and indirect acquisition of a French stock company (including SA and SAS). Consequently, that prohibition equally applies in relation to the direct acquisition of shares of the French company and in relation to any indirect acquisition of its shares, through the purchase of the shares of its parent company, either direct or ultimate parent, whatever the law of incorporation of the parent company.

The prohibition on granting security interests or personal guarantees applies in relation to the securing/guaranteeing of any initial acquisition loan and also to any refinancing of that initial acquisition loan.

### No whitewash

There are no ‘whitewash’ or equivalent procedures available under French law to overcome the prohibition. This therefore has a material impact on the way leveraged financings and their security package are structured in France as follows:

- (a) the prohibition against financial assistance in the context of an acquisition financing does not prevent the Acquisition Company as borrower (**Borrower**) of an acquisition loan facility from granting a share pledge over the shares of the French target company (**Target**) newly acquired through the bank financing (as the shares of the Target are not deemed to be the Target’s assets but rather those of the Borrower); and
- (b) it is not possible under French law to have the Target’s assets (nor the assets of any French law incorporated subsidiary of a target company, whatever the law of incorporation of that target company) secure the acquisition loan facility (or the acquisition tranche of the global financing to be secured) and these assets are typically excluded in their entirety from the scope of the secured property (as are personal guarantees from these French companies) in the context of the acquisition financing. This means that no security can be taken at all over these

assets and that no guarantee may be granted by these French companies to secure/guarantee finance the acquisition financing.

In addition to prohibiting the granting of security interests and personal guarantees under acquisition financing as set out above, French regulations directly prevent the granting of intra-group loans/advances by a Target (or any French law incorporated company in a target group) for the purposes of directly financing the acquisition or refinancing/repaying the acquisition loan facility.

Certain procedures may be utilized to try to mitigate the inconvenience of the French regulations prohibiting financial assistance in the context of an acquisition (e.g., the merger of the Borrower and the Target or debt push down). These procedures may be at risk of being deemed by a French judge to be a deliberate attempt to bypass the prohibition against the provision and therefore ought to be regarded with prudence and caution.

## Penalties

Serious penalties may be incurred for a breach of the financial assistance prohibition. Any transaction deemed to breach the prohibition on unlawful financial assistance may be declared null and void and the managers of the company may be held liable for mismanagement if the company or its creditors suffered any damage from the disputed transaction. Furthermore, the president and the managers of a French stock company may be held criminally liable for a breach of the financial assistance prohibition.

## 18. What are the implications under the corporate benefit laws of France for a company providing Financial Assistance?

As indicated above, it is not possible for a French stock company to provide financial assistance for the purpose of the (direct or indirect) acquisition of its own shares. As the prohibition is absolute and not subject to any exemptions, there is no reason to analyze any requirement applicable with respect to corporate benefit for a French company in relation to granting a loan, guarantee and/or security for the purpose of assisting a third party to acquire (directly or indirectly) the shares of that French company.

It is only where the financing to be put in place in the context of an acquisition also includes additional loans tranches (such as refinancing of existing indebtedness not linked to the acquisition of the French company, working capital facilities for the Target and/or Target group members and/or capex for Target and/or Target group members<sup>10</sup>) that one should consider whether or not a French company may grant a loan, guarantee and/or security to secure the obligations of its affiliates under that additional financing, without breaching laws applicable to corporate benefit (*intérêt social*). It may also be the case that a French company directly accedes to the financing as borrower, in which case it may freely grant any security or guarantee to secure its own obligations under the financing as borrower.

It should be noted that corporate benefit laws are also quite strict in France. Article L. 242-6 § 3 of the Commercial Code prohibits any transaction that is contrary to the interest of a company on whose behalf a transaction is concluded.

## Limitations to upstream and cross-stream guarantees

Upstream and cross-stream guarantees and security are subject to corporate benefit rules and can only be granted if it is in the 'corporate interest' (*intérêt social*) of the French company to grant the

---

<sup>10</sup> The tranche dedicated to the refinancing of a previous LBO financing in the context of a secondary LBO is not included in this list as French companies are prohibited from granting security or a guarantee in relation to this tranche due to the prohibition against unlawful financial assistance).



guarantees/security. This appraisal is in practice carried out on a stand-alone basis at the level of the company rather than at the level of the group to which the French company belongs.

French courts have consistently held that, where a transaction is entered into by a company in favor of another company belonging to the same group, that transaction will not be considered to be a misuse of corporate assets or credit within the meaning of Article L. 242-6 § 3 of the Commercial Code (and therefore will not breach corporate benefit regulation), provided the following conditions are met:

- (a) a genuine group of companies must exist (as opposed to a mere conglomerate) and the transaction must be justified by the existence of a common economic, financial or labor interest and entered into within the framework of a policy defined for the group as a whole;
- (b) the financial burden borne by a given company within the group as a result of the transaction must not be devoid of due consideration or upset the balance between the respective undertakings of the companies in the group; and
- (c) the financial support granted by the company should not exceed the financial capabilities of that company.

In practice, the general view is that a French company can only grant a guarantee/security to guarantee/secure the obligations of a parent company if it receives some form of true and adequate benefit as consideration for the issue of the guarantee or the granting of the security. This concept of true and adequate benefit in this context is determined on a case-by-case basis (for example financial remuneration, existence of cross-guarantees in favor of the company, interest of the company in the financial success of the Borrower or the group). In all cases, it is important that the risk assumed by the company acting as grantor and/or security provider should not considerably exceed the benefit derived from the transaction.

Practically, the overall commitments of the French entity under the guarantee/security need to be limited if that company only acts as guarantor in relation to a financing. There is generally speaking a commonly established approach in relation to dealing with corporate benefit matters in the French market in relation to guarantees. Guarantee and security limitations are negotiated and implemented so that the risk of the nullity of the security and the civil and criminal liability of the managers of the French collateral provider are mitigated as much as possible, as it is considered that all parties to the financing have a common interest in removing these risks. Accordingly, the liabilities of a French company belonging to the target group for upstream and cross-stream guarantees and security are generally limited by reference to amounts derived from the financing and on-lent and outstanding to the French company and its subsidiaries (with a reference to set-off of the intra group liabilities in case of enforcement of guarantees and security). Downstream guarantees are more generally permitted but may remain subject to certain limitations.

Whether or not the granting of a particular guarantee or security (or the granting of a loan) is in the interest of the company is a matter of fact, rather than law. This factual determination is made by the management of the French company in its sole discretion, by considering the above criteria. That determination (which will usually be expressly mentioned in corporate resolutions), however, is not binding on a French court that ultimately will make a determination on the basis of its own appraisal of the facts.

## Penalties

Criminal penalties (imprisonment of up to five years and/or a fine up to EUR 375,000) can be imposed on the president and managers of the French company if the issue of a guarantee or the granting of security is judged to have constituted a breach of the corporate benefit law. The absence of a corporate benefit could also render the relevant guarantee/security unlawful by a decision of a French court and therefore unenforceable against the grantor. This also explains why lenders pay particular attention to having adequate limitations implemented in the financing documentation.

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

On the commencement of insolvency proceedings of a French law incorporated company, the creditors are automatically prohibited from asking for, and obtaining payment of, their claims (due and payable or not) existing at the date of commencement of the insolvency proceedings (except payment by the setting-off of related claims). French law actually freezes the rights of all of the insolvent company's creditors to engage any action against it for payment of their claims (and acceleration of repayment, seizure of assets, actions before courts, etc.).

As a result, in the context of insolvency proceedings in France, secured creditors are not permitted to enforce any security interest over any asset of the French insolvent company and they are put in a position similar to the position of the unsecured creditors (including shareholders), as all those creditors must file their respective claims with the insolvency courts (in order to preserve their claim rights and rankings) and wait for either the potential recovery of the French company (including by way of arrangements with creditors and waivers of debt agreed under the supervision of the courts) or commencement of the liquidation phase if no recovery is achievable.

At the time of the liquidation of the insolvent company, the secured creditors are put in a priority position. The secured creditors are then allowed to exercise their priority rights in relation to the encumbered assets (or their sale proceeds), subject only to the priority of a few specific claims (being primarily employee salary claims and related state insurance public body claims, claims for the legal and administrator fees arising out of the insolvency proceedings and, depending on the type of security taken, 'new money' claims).

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

There are a number of French tax issues relevant to investors.

### Transfer taxes

The registration taxes applicable to the acquisition of shares are as follows:

- (a) transfers of shares in an SA or an SAS are subject to a 0.1% transfer tax (unless the company is a real estate company in France);
- (b) the transfer of shares in an SARL, (*société civile* or *société en nom collectif*) is subject to a 3% transfer tax (with the same exception for real estate), reduced proportionately by an amount corresponding to the ratio existing between EUR 23,000 and the total number of shares (e.g., the sale of 100% of the shares qualifies for a global tax rebate of EUR 23,000);
- (c) the transfer of unquoted shares in a company qualifying as a real estate company in France (i.e., the assets of which mainly (more than 50%) consist of real estate located in France), is subject to a 5% transfer tax with no cap. Transfer tax is assessed on the sale price or fair market value of the shares, whichever is higher. Transfer tax is usually paid by the buyer but both parties are jointly and severally liable for its payment.

Sales of non-French shares are not subject to French transfer taxes, unless their transfer is documented by a written deed signed in France.

### Deductibility of interest and financing costs

Interest used to finance an acquisition is generally deductible for French tax purposes, subject to interest deduction limitations listed below.



### *Limitation of interest rate*

Interest paid on related party debt is deductible only if it complies with the interest rate limit set quarterly by the French tax authorities (2.79% for the fiscal year ending on December 31, 2014). Use of a market interest rate, if higher, is accepted if the borrower can show evidence of the arm's length nature of the interest rate. Loans contracted with direct shareholders with a ownership interest below 5% are subject to the interest limitation rate set by French tax authorities.

### *Limitation of deductibility of interest paid to related entity subject to low taxation on interest (anti-hybrid rules)*

Interest on loans granted by related parties is tax deductible only to the extent that the borrower establishes that the lender is subject, during the same fiscal year, to corporate income tax on the interest received, at a rate not lower than 25% of the corporate income tax rate which would have been due under standard French corporation tax rules (i.e., resulting in a minimum taxation rate of 8.33% to 9.5%).

### *Limitation of deductibility of financial expenses related to the acquisition of controlling interests*

Financial expenses incurred in connection with the acquisition of a controlling interest in another company is not tax deductible unless the Acquisition Company can demonstrate that decisions and control over the shares acquired are effectively taken and exercised by a French parent or by a French company in the same group that exercises control or influence over the target company.

### *Thin capitalization*

Interest deductibility on related party debt is limited under the thin capitalization rules, if, for any given fiscal year, the following three ratios are all exceeded:

- (a) the French borrowing company exceeds a 1.5:1 debt-to-equity ratio computed by comparing its net equity (including share premium and retained earnings) with the average amount of related party debt over the fiscal year;
- (b) the interest paid on related party loans by the borrowing company exceeds 25% of that company's operating profit before tax, increased by the interest and depreciation deducted in the fiscal year; and
- (c) interest paid on related party loans by the French borrowing company exceeds interest which it receives from related parties.

If these ratios are all exceeded in a given fiscal year, the portion of interest which is in excess of the highest of these three limits is disallowed to the extent it exceeds an annual EUR 150,000 threshold. These ratio limitations do not apply where the French borrowing company can demonstrate that its own indebtedness ratio is lower than that of its whole group.

If the company is not thinly capitalized over the subsequent fiscal year, that excess interest (reduced by a 5% portion) may be deferred and deducted as from the following second year depending on the thin capitalization position of the company over the subsequent years.

Note that tax grouping can allow the deduction of additional interest depending on the amount of the tax group's adjusted current result before tax.

The thin capitalization rules also apply to loans (including bank loans secured by security interests or a guarantee granted by a related company group). However, they do not apply to loans in connection with repayment of a previous debt, which was made mandatory by the takeover of the debtor, or the portion of bank loans which are exclusively secured by:

- (a) the pledging of the debtor's shares;

- (b) the pledging of the debtor's receivables; or
- (c) the pledging of shares in a company that directly or indirectly holds the debtor when the holder of those shares and the debtor are members of the same tax consolidated group.

#### *Charasse amendment*

This amendment provides for a limitation of the financial expenses incurred when a company that is a member of a tax consolidated group acquires shares of a target company from a shareholder that controls the tax group, and the target company then becomes a member of the tax consolidated group of the acquiring company.

#### *General limitation of deductibility of financial expenses*

Companies with annual net financial expenses (broadly, financial expenses less financial income, which includes payments under interest rate swaps) exceeding EUR 3 million are entitled to a deduction of up to 75% of their net financial expenses only.

This limitation does not apply to interest disallowed under the other interest deduction limitations described above.

### **Withholding taxes**

#### *Interest*

No French withholding tax applies on interest paid to non-French residents, unless those payments are made outside France to a Non-Cooperative State or Territory (**NCST**). In the latter case, a 75% withholding tax will apply on the interest paid, subject to certain exceptions and to the more favorable provisions of any applicable double tax treaty. For 2014, the NCST list includes the following countries:

- (a) Brunei;
- (b) Guatemala;
- (c) Niue;
- (d) the Marshall Islands;
- (e) Montserrat;
- (f) Nauru;
- (g) Botswana; and
- (h) the British Virgin Islands.

#### *Dividends*

Subject to tax treaty benefit and EU Directive, dividends paid by French companies to non-resident shareholders are subject to a 30% withholding tax (increasing to 75% where shareholders are located in a NCST).

In addition, a 3% additional contribution applies on any dividend distributions made by French companies to French or foreign shareholders. This levy cannot be eliminated by tax treaties; however, it does not apply to distributions made within a French tax group.

### **Capital gains tax**

Typically, exit is achieved through the sale of shares in the French acquisition company. Non-French resident investors holding more than 25% of the shares in the French acquisition company may be



taxed in France at the rate of 45%, if not protected by a tax treaty. In most cases tax treaties provide for the exclusive taxation in the country of residence of the investors. However the issue is to be carefully looked at, as certain tax treaties allow France to tax the gain.

Subject to tax treaty provisions, a non-French resident investor investing through an FPCI may be subject to a 45% withholding tax on gains repatriated through the FPCI if they have held directly or indirectly at least 25% of the FPCI's profits at any time over the past five years.

## Overall tax treatment at the fund level

The most commonly used vehicle for private equity is the FPCI. FPCIs are regulated investment funds, which enjoy full tax transparency for non-resident investors. The tax and governance rules also make the FPCI well suited to a leveraged buyout (unlike regular FCP, FPCI may hold debt instruments, within certain limits, and may issue carried interest shares for the funds managers which enjoy a secure and relatively favorable tax treatment).

Foreign funds would not necessarily establish a FPCI, although some do. Other options include investing through holding companies incorporated in EU countries. It is critical that the holding entity be effectively controlled and managed in the EU country where it is established to enjoy both the EU Directive and the tax treaty protection, both for taxation of dividend flows and on exit. Careful consideration needs to be given to the effective administration of the holding entity and its substance.

## Tax grouping

It is possible to set up a tax consolidated group to offset interest expenses of a French bid vehicle against the French target's profits.

A French company can be the head of a tax group to the extent that 95% of its share capital is not held by another company subject to French corporate income tax (CIT). A tax group can only include French companies subject to CIT having the same fiscal year, and held directly or indirectly at least 95% by the head company. Under certain conditions, it is possible to include French companies held through subsidiaries located in an EU member state within the tax group. Also the Amended Finance Act (2014) extends the scope of the French tax consolidation regime to 'horizontal' tax consolidated groups under certain conditions (i.e., tax consolidation between French sister or cousin companies at least 95% of which are owned, directly or indirectly, through intermediary companies and ultimately by a common EU parent company).

The tax group regime applies on election by the head company and its subsidiaries to allow the computation of the tax group result based on the aggregate profits and losses of each member of the tax consolidated group.

Unless generated before entry into the tax group, tax losses generated by members of the tax group are transferred to the parent company and can no longer be used at their level on a standalone basis if they exit the tax group. Contractual mechanisms can be implemented so that the parent company indemnifies the exiting subsidiary for the loss of all/part of the tax losses it transferred to the tax group during the period that it belonged to the tax group. Carried forward tax group losses can be used with no time limit, but may only be offset against tax group taxable income within the annual limit of EUR 1 million plus 50% of the taxable profits exceeding EUR 1 million.

If the target's shares have been acquired through debt, the holding company can deduct the financial costs related to the acquisition from the target's taxable income. However, the deductibility of financial expenses is subject to interest deductibility limitations.

There are various ways to ensure that the target company may enter the tax group headed by the acquisition company as quickly as possible to avoid the interest expenses being treated at the

acquisition company level as pre-consolidation tax losses which could not be offset against the tax group's profits. This setting up of the tax group is one of the critical aspects to consider.

## **21. What forms of exit are available?**

In a solvent situation the most common forms of exit are a trade sale (either sale of shares or sale of the underlying assets) and, to a lesser extent, an IPO.



## Germany

### 1. What structures do private equity funds typically use to manage their funds?

The majority of private equity funds investing in Germany are foreign funds structured as foreign partnerships (e.g., offshore partnerships such as Guernsey LPs or onshore partnerships such as English or Scottish LPs). These offshore limited partnerships are typically advised by a local fund manager (i.e., a German entity that itself does not hold any participation in the target companies).

There are also private equity funds set up as German entities to manage German funds (mainly smaller funds with individual investors or parallel funds for German investors) raised from their investor base. These funds are typically structured as a German limited partnership structure known as a KG (*Kommanditgesellschaft*) (**KG**) whereby the investors hold limited partnership interests in the limited partnership. A general partner, typically a limited liability company (**GmbH**) or, in some cases the managing limited partner, is responsible for the day-to-day management and the operations of the KG.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in Germany?

Regulatory requirements for private equity funds conducting business in Germany have been significantly increased through the recent implementation of the EU Alternative Investment Fund Managers Directive (**AIFMD**).

#### Management companies

Management companies of German private equity funds must obtain a license from the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*) (**BaFin**) as an alternative investment fund manager (**AIFM**) unless they manage assets of less than EUR 500 million (unleveraged) or EUR 100 million (leveraged), in which case there is only a registration requirement. Management companies in the EU may use the AIFM license of their home member state to also manage German private equity funds.

#### Approval and notification of investment funds

The investment terms and conditions for funds that will be marketed to retail investors in Germany must be approved by BaFin. Investment terms and conditions for funds sold to professional or semi-professional investors do not require approval, but do need to be submitted to BaFin.

Foreign alternative investment funds (including private equity funds) need to be notified to BaFin if marketed to German investors (regardless of the type of investor). The notification requirements depend on whether the fund is from within the EU/EEA, and whether the fund units or shares are marketed to retail investors, semi-professional investors or professional investors. Foreign funds do not require a license to conduct a buyout of a German company if no marketing of the fund units occurs with respect to investors domiciled in Germany.

Furthermore, German private equity funds and non-German private equity funds marketed to German investors (and therefore registered with BaFin) and whose investment terms include the acquisition of control in private companies and funds that cooperate to obtain control over private companies must observe certain rules in relation to their investment activities (e.g., they are subject to a requirement to provide information to BaFin and restrictions on asset stripping).

### 3. Are there any approvals required for investments by foreigners in Germany and, if so, what is the process?

In principle, foreign investors are subject to the same conditions as German investors in terms of licensing and notification requirements. However, investors from non-EU countries may be subject to additional scrutiny by German authorities for reasons of national security. In addition, investments in certain specific sectors (e.g., defense) by any foreign investor, including investors from other member states of the EU, are also subject to restrictions.

#### Foreign investment approvals and notifications

If a non-EU investor acquires at least 25% of the voting rights in a German company, the Federal Ministry of Economics (*Bundesministerium für Wirtschaft und Energie*) (**BMWi**) may carry out an in-depth review of the proposed investment if it has concerns that the investment may constitute a danger to German national security. Based on relevant case law, it is generally understood that this type of review will only take place if the German target company is active in a sector that is relevant in times of crisis (e.g., telecommunications or energy).

If BMWi finds that the transaction may endanger German national security, BMWi will enter into a second-stage review to assess whether that danger is indeed present and whether any measures need to be adopted to remove or reduce it. BMWi is entitled to adopt any measure appropriate to remedy the situation (e.g. it could restrict the voting rights of a foreign investor). In extreme cases, BMWi may even prohibit a transaction or appoint a trustee to unwind an investment that has already been consummated.

BMWi must carry out the first-stage review within a period of two months of the transaction being signed. If it intends to carry out a second-stage review, BMWi must inform the parties of that intention within this two-month period. If it does not act within this initial two-month period, BMWi will be barred from taking any further action. This applies even if BMWi has not learned of the investment before expiry of the two-month period. The second-stage review must be completed within a three-month period.

If investors wish to obtain certainty at an early stage of the transaction in relation to whether BMWi may have any concerns, they can contact BMWi and apply for a so-called ‘Certificate of No Objections’. If BMWi does not initiate an in-depth review within 30 days of the receipt of that application, the Certificate will be deemed to have been granted. Therefore, in cases where there is doubt about whether a transaction may be relevant for German national security, it is advisable to contact BMWi as early as feasible in order to be able to alleviate any concerns that BMWi may have regarding a transaction. If BMWi does have concerns, it is also usually possible to negotiate with BMWi in relation to any appropriate measures and, if necessary, to take these measures into account in the investment agreement.

#### Industry-specific regulation

Investments by any foreign investor in companies from certain industry sectors are also subject to mandatory notification and review in Germany. The notification requirement applies if a non-German investor (including investors from other EU member states) acquires at least 25% of the voting rights in a company which engages in any of the following business operations:

- (a) manufacturing or development of war weapons (generally, weapons for attacking another country);
- (b) manufacturing or development of specially designed engines or gears for main battle tanks or other armored tracked military vehicles;



- (c) manufacturing of IT security products which have been approved for handling classified government matters or key components of those IT security products; or
- (d) operation of a satellite-based remote sensing system for high quality data.

Notifications must be submitted to BMWi, which will carry out an initial review to assess whether the investment may affect material interests of German national security. If BMWi finds that it could do so, it will initiate a second-stage, in-depth review to decide whether material interests of German national security would indeed be affected and which measures must be adopted to remedy that risk. As in relation to the general review procedure described above, BMWi may adopt any measure that is appropriate to remedy dangers to German national security, including a prohibition of the transaction.

BMWi must carry out the initial, first-stage review within a period of one month after receiving the notification. If it does not initiate the in-depth second-stage review within this period, BMWi is deemed to have approved the transaction. The second-stage review, including the decision in relation to any measures to restrict or prohibit the transaction, must also be concluded within a period of one month.

As in relation to the general review procedure discussed above, it is advisable to contact BMWi as early as feasible in order to be able to alleviate any concerns that BMWi may have regarding an investment. If BMWi does have concerns, it is also usually possible to negotiate with BMWi in relation to the measures that should be adopted and, if necessary, take these measures into account in the investment agreement.

### Exchange controls

Not relevant in Germany: the Euro is freely convertible into other currencies and the import and export of capital is free, subject only to certain reporting requirements.

## 4. Who are the relevant regulators in Germany and how much interaction would one generally expect when undertaking a buyout?

The main regulators and authorities that may be relevant for a buyout are:

- (a) the Federal Financial Supervisory Authority (**BaFin**) - supervises AIFM, banks and financial services providers, insurers and other securities market participants;
- (b) Frankfurt Stock Exchange (**FSE**) – the major stock exchange in Germany that provides additional regulations for listed entities;
- (c) state authorities supervising securities exchanges and their operators. For the Frankfurt Stock Exchange (FSE), the competent regulator is a dedicated department of the Hessian Ministry of Economy;
- (d) the Federal Ministry of Economics (*Bundesministerium für Wirtschaft und Energie*) (**BMWi**) - for foreign investment notifications and approvals;
- (e) European Commission (*Bundeskartellamt*) - the competition/antitrust regulator; and
- (f) the tax authorities - *Finanzamt*.

The level of involvement with these authorities in a buyout situation largely depends on the nature of the transaction, and the business sectors in which the parties operate. In a public takeover, there is a high degree of interaction with BaFin. If the transaction involves a regulated industry sector, there may be involvement with other industry-specific regulatory authorities.

However, in most private acquisitions, the transaction-related interaction with public authorities is typically limited to merger clearance by the antitrust authorities. The level of involvement of the

antitrust authorities depends on the size of the undertakings involved, whether they meet relevant merger control thresholds under German or EU Competition Law, and the potential impact of the transaction on competition. The antitrust authorities generally only review a transaction in detail if the private equity investor already holds stakes in companies that are active in the same market as the target, or if it has invested in companies that are actual or potential suppliers or customers of the target.

## 5. How are buyouts typically undertaken in the private and the public markets?

### Private context

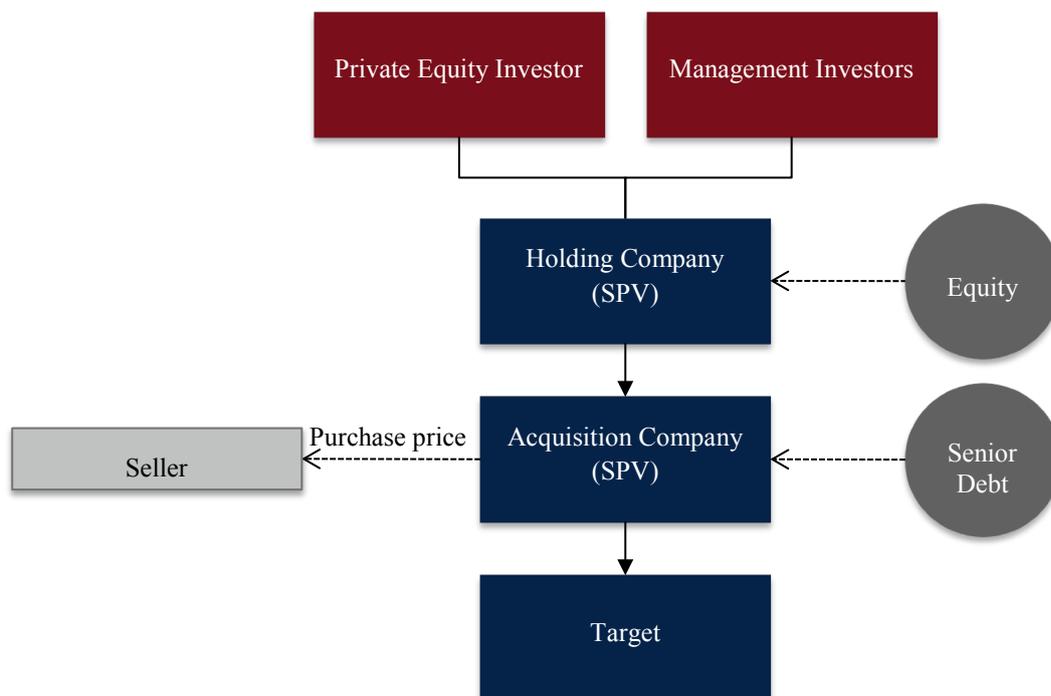
In a private context, transactions are usually undertaken by way of a negotiated acquisition. Sale and purchase documents are prepared, negotiated and executed and those documents record the terms of the sale and acquisition and the rights and liabilities of the parties.

### Public context

In a public context, buyouts of targets listed on regulated markets require a public takeover bid. An offer document outlining the terms of the offer to the shareholders needs to be prepared and, once approved by BaFin, published. In addition, there may be negotiated acquisitions of stakes from major shareholders.

## 6. What is the typical corporate structure used when doing a buyout?

Although acquisition structures do vary from transaction to transaction, it is fairly common to see a two-level holding company structure adopted along the following lines:



This type of structure allows for the senior debt finance to be provided to the Acquisition Company SPV (which is typically organized as a GmbH) while the equity contributions from the private equity fund and the investing managers are contributed at the holding company level and subsequently contributed down to the Acquisition Company SPV in the form of shareholder loans or equity. More elaborate structures invariably exist on larger and more complex deals, particularly where debt



funding involves mezzanine funding sources that may need to be structurally subordinated to the senior loan but rank ahead of any equity contributed by the private equity funds or the investing management.

## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

#### *Private company*

For a buyout negotiated in a private context, the primary legal documents that record the transaction are the sale and purchase agreement and the shareholders agreement between the private equity investors and management. There may also be other ancillary transaction documents prepared depending on the nature of the deal, for example, a subscription agreement, or a transition/shared services agreement.

#### *Public company*

For a buyout in a public context the documentation to be prepared may include:

- (a) a business combination agreement with the target outlining the deal structure in a friendly takeover;
- (b) an offer document outlining the offer to the shareholders; and
- (c) sale and purchase agreements (or other agreements) with major shareholders.

### Banking

The main banking document is the senior facilities agreement under which the senior debt facilities (typically amortizing and non-amortizing term loans with working capital lines and in some instances capital expenditure or acquisition facilities) are documented.

If there is mezzanine debt, there is a separate facility agreement under which the debt is made available and an intercreditor and/or a subordination agreement recording the respective rights of the senior and the mezzanine lenders, the shareholders and sometimes the seller (if providing vendor finance).

Hedging is generally always documented under standardized agreements.

## 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

### Private context

In a private transaction, the buyer is usually protected by way of contractual warranties and indemnities given by the seller in the sale and purchase agreement. The scope of the warranties is usually rather broad and may cover almost every material issue relating to the target and its business. Indemnities tend to be more specific and typically relate to taxes and environmental issues as well as specific issues that have been identified during the due diligence process (e.g., litigation and license issues).

The extent and terms of the warranties and indemnities vary from transaction to transaction, depending on the competitive situations and interests of the parties. However, it is quite usual to expect that limits such as claim thresholds and caps, time limits and adjustments for items otherwise disclosed or accounted for will be agreed. (In private equity exits, restrictions on the liability of sellers are (again) becoming quite aggressive, with a cap as low as 1% of the purchase price being requested

and sometimes agreed). To cope with the risk of the seller not being able to pay the buyer's warranty or indemnity claims, the buyer would usually request that a portion of the purchase price be held in escrow for a certain period of time.

Warranty & indemnity insurance is becoming more common in relation to German transactions, with terms generally in line with UK/European practice.

## Public context

In a public context, the shareholders tendering their shares into the offer do not give any warranties (although if shares are also acquired from majority shareholders, the majority shareholder typically gives a limited set of warranties). All transactions (e.g., incentive schemes or equity participations) agreed between management and the bidder at the time of the offer must be disclosed in the offer document.

## 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

There are no specific laws regulating how conflicts are managed in a management buyout in Germany. However, the German Act on Limited Liability Companies (**GmbHG**) and the German Stock Corporation Act (**AktG**) impose general statutory obligations on directors and officers of a German company, including:

- (a) fiduciary duties;
- (b) an obligation of secrecy;
- (c) a non-compete obligation;
- (d) an obligation to use business opportunity for the benefit of the company; and
- (e) the principle of equal treatment of all shareholders.

According to the German Securities Acquisition and Takeover Act (**WpÜG**), the bidder must disclose any payments or benefits to the management of the target in the context of the offer.

It is common practice for sellers to ask management to review representations and warranties given by the seller in the transaction documents and provide related officers' certificates/management protocols. However, management does not have a legal obligation to provide that documentation under German employment law.

## 10. How are the equity arrangements typically regulated in a buyout?

The equity arrangements in a typical buyout are regulated primarily by the shareholders agreement. Additionally, the relevant company's articles of association may include further regulations regarding the relationship between the shareholders and the constitution of the company (e.g., provisions on additional 'advisory boards') that are of a more general nature.

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

There is a great deal of flexibility under German law in relation to the types of equity instruments that can be granted and the level of rights tailoring that can occur. This can be done by creating different classes of shares issued to management and the private equity fund in a buyout, or by allocating special rights to certain shareholders in the shareholder agreement (e.g., subscription/option rights, dividends, and/or liquidation preference and veto rights).



## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

### German limited liability company (GmbH)

The two main statutory bodies of a German limited liability company (**GmbH**) are:

- (a) the shareholders' meeting (*Gesellschafterversammlung*); and
- (b) the managing director or directors (*Geschaefsfuehrer*).

Other bodies may be set up in accordance with the articles of association (e.g., an advisory board (*Beirat*) or shareholders' committee (*Gesellschafterausschuss*)). In general, a GmbH is managed by one or more managing directors who are directly responsible to the shareholders. The shareholders may issue instructions to the managing directors and therefore have some degree of direct influence on the business of the company.

The appointment of managing directors is usually for an indefinite period and may be revoked by the shareholders at any time, subject to the articles of association and subject to the managing director's rights under his or her employment/executive services agreement. Because of the predominant role of the shareholders' meeting, the style of management of a GmbH is usually informal, with no formal board meetings. Where an advisory board or shareholders' committee is established, there may be regular meetings of these bodies that the managing directors also attend.

As mentioned above, the supreme body of a GmbH is the shareholders' meeting, and as such, the articles of association may provide a list of transactions that are subject to the approval of the shareholders' meeting. In addition, the shareholders' meeting may issue general or specific instructions to the managing directors, and some activities may be delegated to an advisory board or shareholders' committee.

The typical GmbH does not have a supervisory board (i.e., it is a one-tier model). The articles of association may, however, provide for the creation of an optional supervisory board or, if the GmbH has more than 500 employees, it must establish a mandatory supervisory board (two-tier model). The main function of the mandatory supervisory board is to supervise management, inspect the books and records of the company, convene shareholders' meetings as required and be the interface between the shareholders and the managing directors. The composition of an optional supervisory board can be freely determined, whereas a mandatory supervisory board must have three members, unless otherwise determined in the articles of association.

### German stock corporation (AG)

The governance of an AG is structured as a mandatory three-tier system, consisting of:

- (a) the management board;
- (b) the supervisory board; and
- (c) the shareholders' meeting.

The management board is responsible for the management of the AG and its representation *vis-à-vis* third parties. It consists of one or more members. Depending on the number of employees, it may be required to have a board member responsible for employment affairs. Unless otherwise provided for by the articles of association, all members of the management board represent the company jointly. Similar to a GmbH, the signatory power of the management board is unlimited *vis-à-vis* third parties. However, a significant difference between a GmbH and an AG is the greater level of independence of the management board, which generally cannot be restricted by the supervisory board or the shareholders' meeting.

The management board is supervised by the supervisory board. The supervisory board consists of at least three members. Depending on the number of employees, it may be necessary for a certain number of members of the supervisory board to be elected by the employees. The supervisory board is responsible, among other things, for the appointment and removal of the members of the management board and the representation of the AG *vis-à-vis* the members of the management board. Furthermore, the articles of association or the supervisory board must implement an approval catalogue. This is a document setting out the types of transactions for which the management board requires the prior approval of the supervisory board.

The shareholders' meeting appoints and removes the members of the supervisory board (unless they are to be elected by the employees) and is responsible for decision-making of the company with regard to certain matters provided for by law or the articles of association, including the appropriation of profits (dividend distributions, retention of earnings) as well as fundamental decisions regarding the constitution (e.g., amendment of the articles of association) and the existence of the company (dissolution of the company). Even though management decisions, in principle, are made by the management board and are only subject to possible approval requirements by the supervisory board, there may be cases where approval by the shareholders' meeting is also required. According to German case law this will generally apply where management acts result in structural changes to the company (e.g., a sale of all or nearly all of the company's assets). In these cases the consent of the shareholders' meeting with a majority of at least three-quarters of the nominal capital represented is required.

The members of both the supervisory board and the management board are appointed for a maximum period of five years. A reappointment is generally possible. All board members of an AG must be natural persons and there are no requirements regarding the nationality or residency of the board members that are appointed (in fact it is permissible for none of the members of the management or supervisory board to reside in Germany). Nevertheless, non-resident board members must comply with all relevant mandatory and statutory obligations.

Generally, issues regarding the appointment and/or removal of managing directors or a member of the supervisory or voluntary advisory board are governed by the relevant shareholders agreement. It is common for private equity funds to have specific appointment and removal rights in respect of a certain number of members of the advisory board or the supervisory board that may be beyond an appointment or removal for 'good reasons'. However, the appointment or removal of a member of the supervisory board will be formally executed by the shareholders' meeting and, in relation to the members of the management board, by the supervisory board. The managing directors make all personnel decisions except for in relation to the members of the management and/or supervisory board.

### Differential voting rights

Since the private equity funds typically hold a majority of the votes both at shareholders' meetings as well as at the advisory/supervisory board level there is generally no need to provide for differential director voting rights. This may be different if a private equity investor does not hold a majority, for example, if there are several different private equity investors. It is not possible under German corporate law for one member of the supervisory or management board to decide against the majority of the other board members. That means one board member may not overrule a majority decision of the board. The articles of association or the rules of procedure may, however, grant a casting vote in the event of a tie, or a veto right to a specific member of the management or supervisory board.



### 13. What measures are commonly used to give a private equity fund some level of control over key operating and financial decisions made by a portfolio company?

Control over key operating and financial decisions made by the portfolio company is typically dealt with by implementing rules of procedure for management. These rules of procedure are imposed either by the shareholders or, if the company is an AG, by the mandatory supervisory board. In addition, the articles of association of a GmbH may provide for specific veto or information rights as well as requirements for the prior consent of the shareholders or supervisory board for important transactions of the company.

The rules of procedure or the consent requirements in the articles of association typically provide for:

- (a) setting up a budget, cash flow plan or some other financial planning tool;
- (b) specific regular financial reporting obligations of management; and
- (c) a catalogue of decisions by management that are subject to prior consent, including decisions that relate to operating or financial matters.

The rules of procedure for management and the approval requirements in the articles of association are not enforceable *vis-à-vis* third parties. A managing director's or member of the management board's authority to represent the company can generally not be limited in relation to third parties. Accordingly, it would normally not be possible to claim that an action by management is void because the manager breached the rules of procedure. The only way to limit the power of a managing director or a member of the management board would be to implement a 'four eyes' principle by granting him or her only joint power of representation.

### 14. What employment terms are generally imposed on management in a buyout?

Generally, senior management of the target company enters into an executive services agreement with the company. The nature of this agreement largely depends on whether the target company is a GmbH or an AG.

If the target company is an AG, the executive services agreement must be entered into for a fixed term, with a maximum term of five years, whereas if the target company is a GmbH, the agreement may provide for a fixed term but it can also be entered into indefinitely (in which case the agreement includes provisions dealing with the period of notice that must be given before the agreement is effectively terminated). Note that typically a managing director can only be dismissed where there are significant grounds (e.g., gross breach of duty or fraud) and senior management usually requires a minimum notice period of six months or more.

Compensation of senior management and managing directors typically includes a fixed component and a variable component referable to a combination of company and individual performance. The variable payment often amounts to approximately 30% or more of the total compensation.

Equity incentives are generally covered in the shareholders agreement or a side agreement to the executive services agreement rather than in the executive services agreement itself.

### 15. What equity incentives can be offered to management and how are they typically structured?

#### Private company

There is a great deal of flexibility in relation to incentives offered to management.

These incentives generally take the form of ordinary equity or options over ordinary equity. It is also possible to create forms of phantom equity, but careful planning of these phantom equity plans is required.

Management is expected to pay for its equity. Sometimes the price paid by the management is lower than the price paid by the private equity investors ('sweet equity') or a favorable loan is granted to the managers in relation to the purchase of their shares. In some cases, management is offered a 'ratchet' on their equity which will operate to give them a greater overall return if the investment for the private equity fund outperforms certain base return thresholds (usually measured by reference to the fund's internal rate of return on the investment or an absolute money multiple). In Germany, there are different ways that this can be structured. Nevertheless, sweet equity as well as ratchets bear the risk of being treated as income for tax purposes and accordingly could be taxed on a regular tax basis rather than for earnings from a sale of equity (which is a reduction of the tax basis by 40%).

Typically the private equity funds and management enter into a participation agreement that sets out the way the private equity funds and the managers participate in the new company or holding company (depending on the structure). In addition, the future relationship between the private equity shareholders and the management shareholders is regulated in the shareholders agreement. Sometimes the parties enter into only one agreement covering both the participation and the future rights and obligations of the different shareholders.

The shareholders agreement may provide for vesting of the shareholding over a period of time (and vesting may be subject to achieving agreed financial hurdles). The shareholders agreement typically also includes a right to re-acquire a manager's shares if the manager ceases to be employed by the company. 'Good leaver' and 'bad leaver' provisions are very common in the shareholders agreement and provide for different prices to be paid for the shares depending on the category into which the departing manager falls.

In addition, a shareholders agreement typically deals with the following issues:

- (a) drag along/tag along rights;
- (b) trade sale/IPO-obligations (e.g., lock-ups);
- (c) call/put options other than under the leaver scheme; and
- (d) anti-dilution protection for management.

## Public company

In a listed company context or in the case of an AG, incentives to management are more difficult to implement as the bidder must disclose payments or benefits to management of the target in the context of the offer and statutory rules in relation to the remuneration of management apply. Any incentives and, in particular, any participation of management in the buyout needs to be carefully planned.

## 16. How are buyouts typically debt financed and secured?

While it varies from transaction to transaction, typically between 60% and 75% of the cost of an acquisition is provided from debt provided by banks and financial institutions in addition to vendor loans (if any). The amount of debt that can be raised is typically calculated as a multiple of the earnings (EBITDA) of the target business. Germany has a large number of domestic and international banks and financial institutions willing to participate in leveraged finance deals.

Lenders usually expect the equity to be structurally subordinated to the debt finance with the debt being lent to a special purpose finance company which is a wholly-owned subsidiary of the holding company.



Security is usually held by a security agent for the benefit of the lenders. A security package typically comprises security over the assets of the group such as land charges over real estate, a global receivables assignment, account pledges and share pledges. The creation of land charges and share pledges require a (sometimes costly) notarization.

Germany has strict capital maintenance rules aimed at preventing the distribution of share capital to shareholders. A GmbH is not permitted to extend loans to shareholders nor may a group company cross-guarantee the obligations of another group company to the bank lenders unless the repayment claim against the borrower covers the full amount of the loan and the company has entered into a valid domination and/or profit and loss transfer agreement.

Fees are usually documented in a separate letter rather than in the main facilities agreement.

## 17. Are there financial assistance issues to consider when undertaking a buyout?

### Financial assistance

As a general rule, German law does not allow an AG to provide financial assistance to a third party for the acquisition of the AG's own shares (Section 71a of the AktG). The prohibition does not apply, however, to a GmbH. Financial assistance is therefore generally permitted for limited liability companies, unless the act of financial assistance violates capital contributions and maintenance provisions. These capital contributions and maintenance provisions contain extensive limitations and can lead to the same effect as the prohibition in Section 71a of the AktG referenced above.

### Capital maintenance rules

Under German law, granting security in favor of shareholders and affiliated companies (other than subsidiaries, i.e., a company granting security over its assets for debt incurred by its shareholder or affiliated companies (**Up-/Cross-stream Security**)), may, if that security is enforced, be deemed to be a prohibited repayment of the registered share capital to the shareholders and/or may endanger the corporate existence of the company granting the security. To avoid liability of the shareholders or the management of a GmbH, the enforcement of any Up-/Cross-stream Security is generally subject to certain restrictions.

Under Section 30 of the GmbHG, a GmbH (or in the case of a GmbH & Co. KG, its general partner) may not pay to its shareholders any funds that are required to maintain the GmbH's registered share capital.

In general, any direct payment to the shareholder that affects the registered share capital is prohibited. All kinds of other distributions from which the shareholder benefits directly or indirectly, (e.g., if the company grants security over its assets for debt incurred by its shareholder or affiliated companies), may also breach the restrictions set out in Section 30 of the GmbHG.

If a creditor enforces an Up-/Cross-stream Security to satisfy its claims against the shareholder, this qualifies as a payment of funds to the shareholder for the purposes of Section 30 of the GmbHG. The limitations arising from Section 30 of the GmbHG apply in relation to the shareholder only and do not restrict the secured party from enforcing the security. Therefore, the relevant secured party can enforce the security in breach of Section 30 of the GmbHG and the shareholders, as well as the managing directors of the company, may become liable to reimburse the amounts equivalent to the amounts required for the preservation of the registered share capital (Sections 31 and 43 of the GmbHG).

## Corporate existence

The management of the German company and the borrower may be held personally and/or, in very rare cases, criminally liable for breach of the financial assistance/capital maintenance rules. Under Section 64 of the GmbHG, managing directors of a GmbH may be liable for all losses and damages the company suffers itself, if their dispositions or actions led to the insolvency and did not act with the diligence of a prudent business man/woman.

The essential element is the drawing of liquidity from the German company. According to relevant literature, the granting of Up-/Cross-stream Security must be treated as a payment within the meaning of Section 64 of the GmbHG.

Payments to a direct or indirect shareholder by way of Up-/Cross-stream Security may also conflict with the rules and principles of an action threatening the corporate existence (actions causing insolvency), i.e. the prohibition to transfer assets to a shareholder, if that transfer could deprive the GmbH of its ability to meet its obligations towards other creditors when due (Section 43 (3) of the GmbHG and Section 826 of the German Civil Code). If the company disposes of an asset to a shareholder, the company must consider whether:

- (a) the company will be able to fulfill at all times its other obligations as and when they become due; and
- (b) the disposal may jeopardize the existence of the company (*existenzgefährdender Eingriff*).

## Limitation language

To avoid liability of the shareholders or the management of a GmbH, the enforcement of any Up-/Cross-stream Security is generally subject to certain restrictions. The relevant provisions in finance documents (i.e., the loan documentation, any guarantee and any security document) are referred to as 'limitation language', which effectively prevents the secured parties from enforcing the security in certain circumstances that would trigger that liability. This means that enforcement by the bank under the finance documents is generally only permitted against the net assets of the company (i.e., the company's assets, deducting liabilities and the registered share capital). From a bank's perspective, this limits the value of any security obtained, but it is the market standard.

## Debt push down

To improve the position of the lenders, in particular in the context of an acquisition financing, it is important to structure the financing so that the relevant German security providers become either the 'borrower' under the acquisition financing or, less preferably, that they benefit from the financing by way of on-lending.

This can be achieved by way of a so-called 'debt push down', where either existing debt of the relevant target company is discharged with proceeds stemming from the acquisition financing, or where a borrower is merged with the target company.

## 18. What are the implications under the corporate benefit laws of Germany for a company providing financial assistance?

There are no corporate benefit laws in Germany. However, managing directors have a statutory duty to their company to act as prudent businessmen/women. This is a vague concept and the interests of the company group can be taken into account when assessing whether it has been met.

The German Code of Corporate Governance (**GCCG**) applies to listed AGs. Members of the management board and of the supervisory board must declare that they have followed the recommendations of the GCCG.



If there is a violation the transaction is not invalid but the directors, managing board, or supervisory board are potentially liable.

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

Under Germany insolvency laws, there are five categories of creditors:

- (a) Creditors with separation rights - German insolvency law ranks creditors with separation rights and secured creditors ahead of the preferred, general and subordinated creditors. Creditors with separation rights have a right to receive the secured property or right to which they hold an entitlement. A separation right exists, for example, if a creditor has an *in rem right* (such as legal title) to an object or right;
- (b) Secured creditors - Secured creditors have a right to preferential treatment and rank ahead of preferred, general and subordinated creditors. A right to preferential treatment exists if the creditor is secured by a pledge, assignment or other security. Depending on the type of security and the security object, secured creditors may realize the security object themselves or claim satisfaction out of the proceeds from a realization of the security object by the administrator ahead of preferred, general or subordinated creditors;
- (c) Preferred creditors - Preferred creditors are, in particular, creditors whose claims result from transactions entered into by the insolvency administrator. These transactions include any agreements entered into by the insolvency administrator after the institution of the insolvency proceedings, and the continuation of existing agreements. Claims of preferred creditors are settled in full in advance from the insolvency estate;
- (d) General creditors - General creditors are unsecured creditors whose claims have been created prior to the insolvency petition or during the preliminary proceedings by acts of the insolvent company. All unsecured creditors are treated equally and are satisfied out of the insolvency assets on a *pro rata* basis; and
- (e) Subordinated creditors - Subordinated creditors are only satisfied after all other insolvency creditors have been satisfied. The subordination can either follow from a subordination agreement or by operation of law under the German Insolvency Act (e.g. a mandatory subordination of all shareholder loans applies in the case of insolvency proceedings and any repayment of a shareholder loan during the last year prior to the commencement of the insolvency may be revoked by the insolvency administrator.) The equity interests of shareholders are entitled to repayment only after all other creditors' claims have been fully satisfied.

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

A number of German tax issues are relevant. Key issues commonly faced are set out below.

### Overall tax treatment of structure

The form of the entity that is used, both as a fund and to perform the buyout, is a key issue in determining the overall tax treatment of the structure. An important issue is whether the relevant entity is regarded as a 'flow through' (or transparent) entity for German tax purposes.

A fund established in the form of a KG may give rise to flow through treatment (i.e., no tax at the fund level). In this respect, it is necessary to distinguish between income tax or corporate income tax on the one hand, and trade tax on the other. For corporate income tax purposes, a German partnership does not qualify as a taxpayer. However, depending on the fund's structure and activities, trade tax

may be levied at the level of the partnership. With respect to the qualification of partnerships as trading or non-trading partnerships, an administrative letter ruling would provide some guidance.

For non-resident investors, careful consideration needs to be given to the interaction of the German tax treatment of the structure and the tax treatment of the relevant entities in the investor's home jurisdiction. For example, a German permanent establishment and therefore German trade tax liability should be avoided.

### Transfer taxes/stamp duty

No stamp duty is payable. Notarization fees for the transfer of shares is, however, payable by the buyer.

### Deductibility of interest and financing costs

Interest and financing costs used to finance an acquisition are generally deductible for corporate investors for German tax purposes. However, under a so-called 'interest barrier', the interest deductibility is generally limited to 30% of the taxable EBITDA if the net interest expense exceeds EUR 3 million.

To maximize deductions associated with interest and other financing costs, the German entities, including the German Acquisition Company/SPV, generally establish what is called a 'fiscal unity'. Another commonly used tool to achieve a debt push down for tax purposes is a merger of the acquisition vehicle and the target company (described above in question 17).

### Withholding tax

For non-resident investors, German withholding tax is an important issue to the extent returns will be repatriated by way of dividends. In general, dividends from a German company to a shareholder located in another EU member state can be exempt from German withholding tax of 26.375%, provided that the requirements of the Parent-Subsidiary-Directive are met (in particular, the requirement relating to a minimum participation of 10% held for at least 12 months by a company). Non-EU foreign shareholders may be eligible for a (partial) refund of, or exemption from, German withholding tax based on bilateral double taxation agreements.

However, with respect to the structure of offshore private equity funds, domestic anti-treaty shopping rules need to be taken into account. The exemption from German withholding tax on dividend distributions is generally only available to the extent the shareholder generates active income from its own business activities. To ensure a full exemption from the German withholding tax on dividend distributions, a modified acquisition or investment structure might be appropriate.

### Capital gains tax

The German income tax/capital gains tax consequences of any exit either by trade sale or initial public offering (IPO) need to be reviewed carefully.

Under German domestic tax law, the disposal of shares by a corporate shareholder is generally tax-exempt in the amount of 95%, so that only 5% of the capital gain is subject to tax.

In the case of non-resident investors, it is important to consider whether tax treaties limit Germany's right to tax a capital gain. Most tax treaties provide for the exclusive taxation in the country of residence of the investors.



## 21. What forms of exit are available in a solvent situation?

In a solvent situation the most common forms of exit are an IPO or a trade sale (share or asset deal). It is fairly common in Germany for private equity funds to run a ‘dual track process’ (meaning both forms of exit are conducted until a decision is made for either one of the two exit forms). The purpose is to test which form of exit offers the best pricing and terms.

It is also common for private equity funds to achieve a return on investment during the life of the investment by undertaking a leveraged recapitalization.

## Hong Kong

### 1. What structures do private equity funds typically use to manage their funds?

The structure commonly used by private equity funds to manage the funds raised from their investor base is the limited partnership that is commonly constituted in the Cayman Islands for tax purposes.

The investors hold limited partnership interests in the partnership and a general partner has day-to-day management control of the partnership and its operations. The general partner typically delegates the investment management functions to an investment manager or investment adviser in Hong Kong.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in Hong Kong?

Generally, a private equity fund does not need to be licensed in Hong Kong or authorized by any regulator in Hong Kong if its securities are not offered to the public in Hong Kong.

The offering of securities or interests in a private equity fund is a form of securities offering in Hong Kong which is regulated by the Securities and Futures Ordinance and, if the private equity fund is structured in the form of a company formed or registered in Hong Kong, the Companies (Winding Up and Miscellaneous Provisions) Ordinance (**Companies Ordinance**). In brief, there are certain safe harbors under these two ordinances that can be relied on for the private placement of securities or interests in private equity funds in Hong Kong.

A fund management company which carries on asset management business in relation to securities in Hong Kong needs to obtain a license from the Securities and Futures Commission (**SFC**) to conduct Type 9 regulated activity (asset management).

In addition, persons who carry out asset management activities for the fund are required to obtain a representative's license from the SFC.

### 3. Are there any approvals required for investments by foreigners in Hong Kong and, if so, what is the process?

#### Foreign investment

Generally, investments made by foreigners in Hong Kong are not subject to the approval of any governmental or regulatory agency in Hong Kong except for companies in certain regulated industries such as banking, insurance, securities and telecommunications. In these situations, there are statutory provisions regulating the change of ownership or the acquisition (even of a minority interest), disposal or amalgamation of the regulated business.

#### Exchange controls

Hong Kong applies no controls on the movement of foreign exchange. Similarly, there are no restrictions on investment or repatriation of capital or remittance of profits or dividends to or from a Hong Kong company and its shareholders. In certain circumstances, withholding tax may be payable on royalty payments. There are no limits on the amount of profits which may be remitted to foreign investors, subject to restrictions in the Companies Ordinance concerning maintenance of company capital.



#### 4. Who are the relevant regulators in Hong Kong and how much interaction would one generally expect when undertaking a buyout?

The primary regulatory authorities in Hong Kong in a corporate context are:

- (a) the Securities and Futures Commission (**SFC**) – an independent non-governmental statutory body responsible for regulating the securities and futures market in Hong Kong;
- (b) the Stock Exchange of Hong Kong Limited (**SEHK**) – operates and maintains a stock exchange in Hong Kong and is the primary regulator of Stock Exchange participants (such as securities dealers) with respect to trading matters, and of companies listed on the Main Board and the Growth Enterprise Market of SEHK;
- (c) the Hong Kong Companies Registry (**Companies Registry**) – responsible for providing services to:
  - (i) incorporate local companies and register non-Hong Kong companies;
  - (ii) register documentation required by the various ordinances administered by the department, principally the Companies Ordinance;
  - (iii) provide the public with services and facilities to inspect and obtain information held by the department on the various statutory registers and data of companies incorporated and registered with the department; and
  - (iv) ensure compliance by companies and their officers with their obligations under the relevant ordinances; and
- (d) the Inland Revenue Department – responsible for tax administration in Hong Kong. Among certain other ordinances, the Commissioner of Inland Revenue is also responsible for the administration of the Stamp Duty Ordinance and the Business Registration Ordinance.

The level of expected involvement with these regulatory authorities in a buyout situation depends to a large extent on whether the transaction involves a public company or a private company. Transactions involving public companies (such as a public takeover) generally result in greater interaction with the SFC and SEHK.

#### 5. How are buyouts typically undertaken in the private and the public markets?

##### Private companies

A buyout is generally undertaken by way of a private acquisition that is concluded after negotiations between the parties. The parties negotiate and execute a sale and purchase agreement that records the terms and conditions of the acquisition as well as the rights and liabilities of the parties involved.

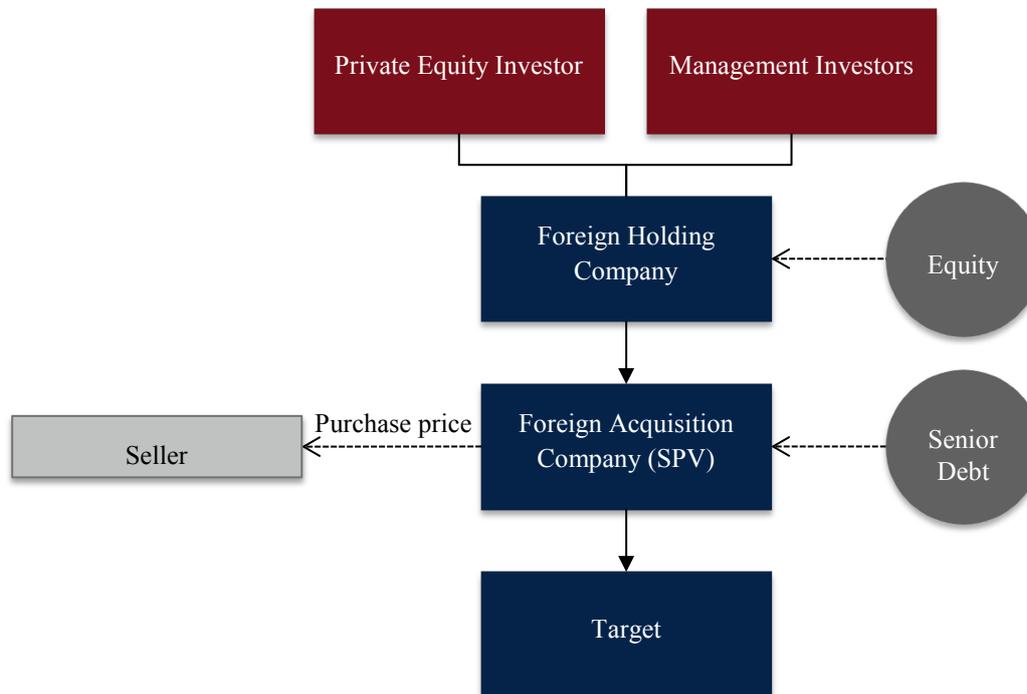
In recent years, it has been increasingly popular for buyouts of a private company to take place following an auction process where several competing bidders are invited by the seller to bid for the target company and where the seller ordinarily concludes a sale and purchase agreement with the bidder that offers the highest price and the most favorable contractual terms.

##### Publicly listed companies

A buyout is typically undertaken by way of a private acquisition coupled with a general offer or by way of a scheme of arrangement. The general offer and the scheme of arrangement must comply with applicable statutory provisions that govern the process of the takeover or scheme of arrangement.

## 6. What is the typical corporate structure used when doing a buyout?

The choice of the corporate structure used when undertaking a buyout is typically tax driven. Funds may undertake a buyout of a company directly or through an investment holding company. More elaborate structures are used on larger and more complex deals. A common corporate structure is as follows:



A notable feature of the market in Hong Kong is that the special purpose acquisition vehicles incorporated for the buyout (Holding or Acquisition Company SPV) are often formed offshore in a tax advantageous jurisdiction such as the Cayman Islands or the British Virgin Islands.

As discussed in more detail in question 20, a further consideration is the level at which debt financing is injected. If a Hong Kong holding company is used to acquire the Hong Kong target company and debt (whether shareholder or third-party) is injected at the holding company level to finance the buyout, to the extent that the investment in the target company does not generate any assessable profits for the Hong Kong holding company, the interest expense would be non-deductible. Therefore, since the dividends from the Hong Kong target company are exempt from tax, the deductibility of the financing costs is an issue in this case.

## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

#### *Private company*

Typically, before negotiations begin for a buyout, the investor and the target company sign a confidentiality agreement.

Except in the case of an auction process, negotiation usually begins with the circulation of a term sheet or memorandum of understanding.

Prior to beginning detailed due diligence and negotiation of contractual terms, a well advised investor may also request a period of exclusivity, during which the seller cannot 'shop' the target. This



arrangement may be included within the confidentiality agreement or in a separate exclusivity agreement.

After due diligence in relation to the target company is completed, the share purchase agreement, asset purchase agreement, subscription agreement or investment agreement are executed. Typically, if the company is not wholly-acquired, a shareholders agreement is also entered into by the investor, the target company and the existing shareholders.

Other documents that may be prepared when undertaking a buyout include employment agreements between key employees and the target company, an employee share option plan, management or service agreements and a registration rights agreement.

#### *Publicly listed companies*

In the context of buyouts involving publicly listed companies, additional documentation may be required to effect the general offer or the scheme of arrangement.

In a general offer, the primary document for the purchaser is an offer document. This includes certain prescribed disclosures together with the terms of the offer. The primary document for the target company is the response document, which must contain certain prescribed disclosures.

In a scheme of arrangement, the primary document is the scheme booklet that is sent to target stakeholders participating in the scheme. This sets out relevant information in relation to the scheme and its terms and notices of meetings for the scheme meetings to be convened.

#### Banking

The main banking document is the facilities agreement under which the terms of the loan made to the company are documented. Typically, separate security documents are executed by which the target company provides security for the loan granted to it. The nature of the security depends on the circumstances and can include fixed and floating charges.

If there are different debt providers, their relative positions depend on subordination and other contractual arrangements negotiated between the parties. If there are different tranches of debt finance, subordination is typically implemented through an intercreditor agreement.

### **8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?**

A private equity fund usually seeks a full range of warranties and indemnities from the seller and management as a form of buyer protection when undertaking a buyout. Part of the purchase consideration may be withheld or placed in escrow for a fixed period to meet any warranty or indemnity claim. It is also common for a fund to set conditions precedent to the acquisition which need to be fulfilled (or not triggered) by completion. A fund may also obtain warranty and indemnity insurance. Warranty and indemnity insurance has not historically been frequently used, but is becoming more commonplace.

### **9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?**

#### General

There are no specific laws regulating how conflicts of interest should be managed in a typical management buyout. Hong Kong law does, however, impose general obligations on directors to act honestly, in good faith and in the best interests of the company as a whole. In discharging his or her duties towards the company, a director must also exercise reasonable care and diligence and exhibit a

degree of skill that may be reasonably expected from a person of his or her knowledge, skill and experience. This duty was formally codified in the Companies Ordinance from 3 March 2014.

As an agent of the company, a director stands in a fiduciary relationship with the company and must not put himself or herself in a position of conflict, or engage in any improper use of any information acquired by way of his or her position in the company to gain an advantage to himself or herself or any other person or cause a detriment to the company.

Management may also be in a position of conflict due to its contractual obligations to the company. The service agreements typically impose obligations that have to be fulfilled. However, management/transaction protocol letters are not common.

## Listed companies

The Code on Takeovers and Mergers introduces certain safeguards in the context of a takeover. For example, a director should only consider the interests of the shareholders as a whole when he or she is giving advice to shareholders and must not have regard to his or her own interests or those derived from personal or family relationships. If a board of directors receives an offer or is approached with a view to an offer being made, the board must also establish an independent board committee to make a recommendation in relation to whether the offer is, or is not, fair and reasonable, and in relation to acceptance or voting. The independent board committee must, as soon as reasonably practicable, approve the appointment of a competent independent financial advisor to advise on the offer and, in particular, advise whether the offer is fair and reasonable and whether the offer should be accepted.

Finally, for companies listed on SEHK, the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (Listing Rules) may require the company to make appropriate disclosure in relation to connected transactions (and continuing connected transactions), which include a transaction between a director or his or her associates (on the one hand) and members of the listed group (on the other), and/or that the transactions be conditional on prior independent shareholders' approval (depending on the nature, scope and size of the transaction), unless an appropriate waiver has been granted by SEHK.

## 10. How are the equity arrangements typically regulated in a buyout?

The equity arrangements in a buyout are typically regulated by a shareholders agreement entered into by the existing shareholders of the company and the new investors. Further, the memorandum and articles of association of the company are often amended to include the specific share rights that attach to the relevant classes of security to be issued in connection with the buyout.

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different shareholders?

### General

Generally, Hong Kong law does not impose any restrictions on the classes of equity security that can be granted, or the level of rights tailoring that can occur among different stakeholders (e.g., management and the private equity fund) in a buyout. Shares having any type of rights may be created as designated among the shareholders of the company. Typically, the classes of equity security include ordinary shares, preference shares or convertible debt instruments. Preference shares or convertible debt instruments are favored by venture investors.

### Redeemable preference shares

The Companies Ordinance provides for certain rules in relation to the redemption of redeemable shares in Hong Kong companies. Redeemable shares may be redeemed out of distributable profits of the company or out of the proceeds of a fresh issue of shares made for the purposes of the redemption.



Since 3 March 2014, redeemable shares may also be redeemed out of capital if the required procedure is followed. The company has an obligation to notify the Registrar within 15 days on the redemption of any redeemable shares, specifying the shares redeemed and the amount paid for the relevant shares.

## Rights tailoring for offshore holding companies

As noted in question 6, a feature of the market in Hong Kong is that the holding company and acquisition vehicle (Acquisition Company or SPV) is often formed offshore in a tax advantageous jurisdiction such as the Cayman Islands or the British Virgin Islands. The corporate laws of these offshore jurisdictions have fairly flexible rules that allow for a high level of rights tailoring to occur between among shareholders.

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

### General

Typically, the shareholders agreement sets out the relationships, rights and obligations among the investor, the target company and the existing shareholders of the target company. The shareholders agreement and the articles of association govern matters concerning board constituency, differential director voting rights and the removal of directors.

### Board constituency

#### *Private companies*

Certain specific groups of people are not allowed to hold directorships (e.g., persons who have been disqualified by court orders to act as directors, undischarged bankrupts, or persons under 18 years of age). A body corporate cannot act as a director of a company, unless it is a private company that is not a member of a group of companies of which a listed company is a member. There are no residency requirements in relation to the directors of a Hong Kong company.

A private company must have at least one natural person as a director.

#### *Public companies*

A public company must have a company secretary and at least two directors, one of whom may be the company secretary. It must not have a body corporate as its director. There is no requirement under the Companies Ordinance that a director must be a Hong Kong resident.

### Appointment and removal of directors

#### *Private companies*

There is no provision in the Companies Ordinance that prescribes the manner in which directors are to be appointed. Appointment and removal of directors is usually dealt with in the company's articles of association, and it is common for private equity funds to have specific appointment and removal rights in relation to a certain number of directors in their portfolio companies.

#### *Publicly listed companies*

The Listing Rules contain special provisions in relation to the qualification to act as a director of a company whose shares are listed on SEHK, the board constituency and the appointment and removal of directors. In particular:

- (a) a person who is appointed as a director of a listed company must satisfy SEHK that he or she has the character, integrity, experience and competence to serve as a director of a listed company;

- (b) every board of directors of a listed company must include at least three independent non-executive directors, at least one of whom must have appropriate professional qualifications or accounting or related financial management expertise. A listed company must also appoint independent non-executive directors representing at least one-third of the board;
- (c) the Code on Corporate Governance set out in the Listing Rules (**CG Code**), provides, as a principle, that the roles of the chairman and the chief executive officer must be separate and must not be performed by the same individual; and
- (d) every director must retire by rotation at least once every three years. The CG Code provides, as a recommended best practice, that a nomination committee comprising a majority of independent non-executive directors ought to be established.

### 13. What measures are commonly used to give a fund some level of control over key operating and financial decisions made by a portfolio company?

The fund usually has representation on the board of the company and may request that certain matters be subject to:

- (a) supermajority vote; or
- (b) where a different class of shares are held by the fund (e.g., preference shares), the veto right of shareholders of that class if it wishes to have a say in the management and direction of the company.

Representation on the board may also include a presence on the audit and remuneration committees. A shareholders agreement or the memorandum and articles of association of a company can entrench the fund's right to appoint a majority of members to the board for private limited companies and the requirement to subject certain matters to supermajority vote or the veto right of shareholders of a particular class.

The fund may create particular corporate governance and approval authority workflows to impose restrictions on management in undertaking any fundamental matters without board approval (e.g., matters such as a major acquisition or disposal, or large projects). The fund may also secure direct involvement in the daily management of the portfolio company by nominating key officers such as the chief executive officer, the chief financial officer and the chief technology officer.

### 14. What employment terms are generally imposed on management in a buyout?

Long-term agreements are entered into in relation to key personnel of the target company to ensure continuity. Key employment terms include non-compete clauses, confidentiality clauses and provisions for 'gardening leave' to mitigate risks when key personnel resign.

Incentive plans tied to company performance may also be introduced to ensure long-term retention of the management.

### 15. What equity incentives can be offered to management and how are they typically structured?

Incentive plans for management are generally structured on a long-term basis. However, short-term incentives based on annual results are not uncommon. If the fund decides to take the company public, stock options (with or without lock-ups) are a typical incentive available.



One common incentive employed to ensure that the management team is committed to the business of the company is the ratchet mechanism. This mechanism enables the relevant percentage of equity held by management and the fund to alter according to management's performance. It provides management with an incentive to increase or retain its equity in the company in proportion to how well it performs.

The type of ratchet mechanism adopted is typically tax-driven, the most frequently used of which include the redemption of the fund's shares (where the fund takes a part of its equity in the form of redeemable shares) and variation of rights attached to shares (where the articles of association of the company may be drafted to provide for automatic variation of the rights attached to the fund's or management's shares on achievement of performance targets).

## 16. How are buyouts typically debt financed and secured?

### Lending

The debt structure generally consists of senior debt and mezzanine debt. Senior debt is usually made available by banks and financial institutions. Components of senior debt include term loans and revolving credit facilities.

Mezzanine debt ranks behind senior debt but ahead of equity capital. It is usually injected by the fund providing the equity, the seller (if it wishes to maintain a minority interest) or a senior debt provider (in addition to the senior debt).

### Security

Security is typically obtained through the usual mortgages and charges (fixed and floating) over the acquired assets or the shares acquired, subject to compliance with the financial assistance provisions of the Companies Ordinance. Usually, the relative priority of security depends on the contractual arrangements negotiated between the parties.

## 17. Are there financial assistance issues to consider when undertaking a buyout?

There are certain prohibitions on a company, private or public, incorporated in Hong Kong providing financial assistance in connection with the acquisition of shares in itself or its parent company under the Companies Ordinance.

### Prohibition

Section 275 of the Companies Ordinance generally prohibits a company incorporated in Hong Kong from giving financial assistance directly or indirectly for the purpose of acquiring shares in that company or its holding company or for the purpose of reducing or discharging liabilities so incurred. Financial assistance includes assistance given by way of guarantee, security, indemnity, loan, novation or other similar agreement, gift or any other assistance by which the company's net assets are reduced to a material extent.

Section 275 of the Companies Ordinance applies only to financial assistance given by the target or by any of its subsidiaries. Therefore, the prohibition does not apply where the assistance is given by a parent in respect of an acquisition of its subsidiary's shares or by a subsidiary to assist in the acquisition of its sister subsidiary's shares. Also, the prohibition applies only to financial assistance given by a Hong Kong subsidiary for the acquisition of shares in its Hong Kong holding company. It generally does not restrict a Hong Kong subsidiary from giving financial assistance for the purpose of acquiring shares in its offshore-incorporated holding company.

In terms of timing, Section 275 applies to financial assistance given either:

- (a) before or at the same time as the acquisition; or
- (b) to reduce or discharge a liability incurred for the purpose of (i.e., after) the acquisition.

### Exceptions

The Companies Ordinance provides that certain specified transactions will not constitute unlawful financial assistance (Sections 277 to 281). They are:

- (a) where the company's principal purpose in giving the assistance is not for the purpose of any acquisition or reducing any relevant liability, or even if the principal purpose of the giving of the assistance was for any acquisition or reducing any relevant liability, it was an 'incidental part of some larger purpose' and the assistance is given in good faith in the interests of the company;
- (b) a distribution by way of dividend lawfully made;
- (c) a distribution made in the course of a company's winding up;
- (d) an allotment of bonus shares;
- (e) a reduction of capital in accordance with Division 3 of the Companies Ordinance;
- (f) a redemption or purchase of shares made in accordance with Division 4 of the Companies Ordinance;
- (g) anything done in accordance with a court order under Division 4 of the Companies Ordinance;
- (h) certain arrangements made under section 237 or section 254 of the Companies Ordinance;
- (i) the lending of money by the company in the ordinary course of its business where the lending of money is part of the ordinary course of business of the company;
- (j) the provision of financial assistance for the purposes of an employee's share option scheme; and
- (k) loans to employees (other than directors) to purchase shares.

Some of the exceptions apply to a listed company only if the company has net assets that are not reduced by the giving of the financial assistance or to the extent those assets are reduced, the assistance is provided by a payment out of distributable profits.

In practice, the most useful exception in the above list is the 'lawful dividend' exception, which enables a purchaser to use funds in the target to assist the purchaser to finance the acquisition to the extent those funds can be extracted as a dividend paid by the target. That dividend would have to comply with the rules governing the payment of dividends under the Companies Ordinance, and also with the company's articles of association.

### Authorization procedures - General

The general prohibition on the giving of financial assistance can be relaxed on compliance with certain prescribed formalities, commonly known as 'whitewash procedures'.

The new authorization procedures introduced by the Companies Ordinance allow all companies (both public and private) to give financial assistance for the purchase of their shares subject to the



satisfaction of the solvency test (Sections 205 and 206 of the Companies Ordinance) and the obtaining of the relevant approvals as described below.

## Solvency Statement

The Companies Ordinance requires the company to prove compliance with the ‘solvency’ test by preparing a statement (which is not required to be in any specified form) (**Solvency Statement**). The Solvency Statement must be completed and signed by a majority of the directors of the company voting in favor of giving the financial assistance.

The Solvency Statement provides that the directors have formed the opinion regarding the company’s initial situation immediately following the date on which the assistance is proposed to be given, that there will be no grounds on which the company could then be found to be unable to pay its debts, and either:

- (a) if it is intended to commence winding up within 12 months of that date, that the company will be able to pay its debts in full within 12 months of the commencement of the winding up; or
- (b) in any other case, that the company will be able to pay its debts as they fall due during the period of 12 months immediately following the giving of financial assistance.

A director, in the course of forming that opinion, must inquire into the company’s state of affairs and prospects and take into account all the liabilities of the company (including contingent and prospective liabilities). The Solvency Statement must be delivered to the members within 15 days after it is signed.

## Auditors’ report

Hong Kong law does not require a report to be produced by auditors to the directors of the company giving financial assistance. In practice, however, it is advisable that an auditors’ report be obtained, as it would:

- (a) constitute independent advice given to both the lenders and directors; and
- (b) help the lenders in an acquisition finance transaction in their assessment of whether the company would pass the net solvency test.

## Authorization procedures

The three relevant authorization procedures are:

- (a) approval of the board of directors where the aggregate amount of financial assistance does not exceed 5% of the company’s paid-up share capital and reserves (Section 283 of the Companies Ordinance);
- (b) approval of the board of directors together with approval of all of the members by written resolution (Section 284 of the Companies Ordinance); or
- (c) approval of the board of directors together with approval of the members by ordinary resolution (Section 285 of the Companies Ordinance), subject to the right of members holding at least 5% voting rights of the company to petition to the court for a restraining order (Section 286 of the Companies Ordinance).

The above procedures are, among other things, subject to the following conditions:

- (i) resolutions of the directors of the company which proposes to give financial assistance are passed before the assistance is given, resolving that the company should give the assistance and that the giving of the assistance is in the best interests of the company and the terms and conditions under which the assistance is to be given are fair and reasonable to the company

(and the grounds for those conclusions should be set out in full) but in the case of paragraph (c) above, the resolutions should also resolve that the giving of the assistance benefits those members of the company not receiving the assistance;

- (ii) on the same day that the directors pass the resolutions, the directors who vote in favor of it make a Solvency Statement that each of the directors making it has formed the opinion that the company satisfies the solvency test in relation to the financial assistance;
- (iii) in the case of paragraphs (a) and (c) above, a copy of the Solvency Statement and a notice must be sent to each member of the company (except that the notice is required to be sent at least 14 days before the day on which the ordinary resolution is proposed) and the information required to be provided in the notice is set out in Section 283(4) and Section 285(1)(c) of the Companies Ordinance, respectively;
- (iv) in relation to paragraphs (a) and (b) above, the assistance is given not more than 12 months after the day on which the Solvency Statement is made; and
- (v) in relation to paragraph (c) above, the assistance is given not less than 28 days after the day on which the ordinary resolution is passed and not more than 12 months after the day on which the Solvency Statement is made.

### Criminal and Civil Liability

If a company contravenes the prohibitions set out in Section 275 of the Companies Ordinance, the company and every responsible person of the company commit an offense and each is liable to a fine of HKD 150,000 and to imprisonment for 12 months.

The Companies Ordinance specifically provides that any unlawful financial assistance will not be rendered invalid and any contract or transaction connected with it is not affected only because of the contravention (Section 276 of the Companies Ordinance).

## 18. What are the implications under the corporate benefit laws of Hong Kong for a company incorporated in Hong Kong to provide financial assistance?

### General principles

In Hong Kong, directors of a company have a common law duty to act in the best interest of the company, and to exercise powers and take actions that will benefit the company commercially. In addition, the Companies Registry has also issued non-statutory guidelines that outline the general principles for a director in the performance of his/her functions and exercise of his/her powers, which embody the requirement that the directors should act in the best interest of the company.

When considering providing financial assistance for the acquisition of the company's shares or shares in its holding company, directors must decide whether there is any commercial benefit to the company in providing that assistance. The leading authority on the issue of 'commercial benefit' is the English Court of Appeal decision in *Rolled Steel Products (Holdings) Limited v. British Steel Corporation* ([1985] 2WLR 908), which courts in Hong Kong are likely to follow in determining the circumstances in which a local company can give a guarantee or grant security.

As discussed above, when considering providing financial assistance for the acquisition of the company's shares or shares in its holding company, directors must consider (and resolve) whether:

- (a) the company should give the assistance;
- (b) giving the assistance is in the best interests of the company and (in the case where an ordinary resolution is to be passed) will benefit those members not receiving the assistance; and



- (c) the terms and conditions under which the assistance is to be given are fair and reasonable to the company and (in the case where an ordinary resolution is to be passed) to those members not receiving the assistance (Sections 283 to 285 of the Companies Ordinance).

In addition, directors also owe a duty to the company to exercise reasonable care, skill and diligence (Section 465 of the Companies Ordinance).

### Relevant law

Having taken into account that decision and the *de facto* abolition of the *ultra vires* doctrine in 1997, the relevant law in Hong Kong appears to be as follows:

- (a) if the company's articles of association has an objects clause (with few exceptions, Hong Kong companies are now no longer required to have an objects clause in their articles of association) and it does anything which it is not authorized to do by its articles, then that act is not automatically invalid by reason only that it is not authorized by its articles (although it appears that that act may be rendered void on other grounds, where applicable). Under section 118 of the Companies Ordinance, a transaction is voidable if the parties to the transaction include a director of the company or its holding company or an entity connected with that director. However, a member of the company may bring proceedings to restrain the company from doing an act that is in breach of its stated objects;
- (b) where a company's articles of association have an objects clause which does not allow the company to give a guarantee or grant security, there is a risk that a guarantee given or security granted will be challenged. Therefore, the company's articles of association should be reviewed to ensure that the company is allowed to give a guarantee and grant security. If an amendment to the articles of association of the company is necessary, the amendment can be made by the shareholders by way of special resolution and notice of that amendment in a specified form (together with a copy of the reprinted articles as amended) should be filed with the Companies Registry;
- (c) if the company's memorandum of association contains an express authority to give a guarantee or grant security, it is a question of construction in each case as to whether the express authority to give a guarantee or grant security is an 'independent object' or a 'mere power' ancillary to the main objects. Any 'power' should be exercised for purposes reasonably incidental to the 'objects' of the company;
- (d) directors have a general duty to act bona fide for the benefit of the company in exercising their powers. One factor that will be taken into account in determining whether the directors are exercising their powers properly is whether the guarantee or security is for the commercial benefit of the company. While commercial benefit is a factual matter in each case, the practical steps that could be taken to reduce the risk of commercial benefit arguments being successfully raised by the most likely objectors (the company's shareholders and creditors) are:
  - (i) obtaining the unanimous approval of the company's shareholders to the giving of the guarantee or the granting of security (see Section 284 and Section 285 of the Companies Ordinance – under the authorization procedure, the members of the company must pass a written resolution or an ordinary resolution approving the giving of the financial assistance); and
  - (ii) obtaining a statement from the company's directors that the company will not be unable to pay its debts as a result of giving the guarantee or granting security (under Section 205 of the Companies Ordinance, the directors are required to give the Solvency Statement in which they form the opinion that there will be no grounds that the company will be unable to pay its debts on the company's giving financial assistance); and

- (e) if the authority to give a guarantee or grant security is an independent object (as may be the case for banks and financial institutions), it appears that the issue as discussed in paragraph (b) above would be less significant, but this is not certain. The question will need to be considered with reference to the actual business that the company carries on.

## Group benefit

Further, Hong Kong law generally does not recognize the concept of group benefit. When a parent company gives a guarantee or grants security in respect of a subsidiary's obligations, the commercial benefit to the parent can be clearly established. However, when a subsidiary company gives a guarantee or grants security in respect of its parent's obligations, it is often more difficult to establish what the commercial benefit is to the subsidiary.

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

Hong Kong insolvency laws provide for a basic ranking of claims among debtors of the company.

The general law of property applies in an insolvency situation and secured creditors take priority over unsecured creditors. Among secured creditors, a legal charge prevails over an equitable charge, unless the equitable charge was created first and the legal chargee knew of the prior charge.

The Companies Ordinance provides for a class of preferential creditors, such as employees whose wages or salaries are unpaid and any statutory debts. These claims take priority over unsecured creditors in the event of a company winding up.

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

The fund's intentions in relation to the acquisition (e.g., short-term versus long-term holding), the nature of the target's business (e.g., PRC business, revenue generating versus capital growth potential) and potential exit strategies (e.g., potential listing) are some of the considerations that would determine the tax structure for the buyout. A number of Hong Kong profits tax and stamp duty issues are relevant.

The common key issues are set out below.

### Stamp duty

In the case of a share acquisition of a Hong Kong company, each of the buyer and the seller must execute a contract note. Each contract note is liable to stamp duty at the rate of 0.1% of the consideration or the value of the shares transferred. Therefore, the total stamp duty exposure is 0.2% of the consideration or the value of the shares transferred (whichever is the higher).

Where the amount of stamp duty payable on a company acquisition is likely to be significant, certain techniques (e.g., a fresh allotment of shares or reclassification of existing shares) may be adopted to minimize the duty. If those techniques involve steps that have no commercial or business purpose, the Collector of Stamp Revenue may seek to apply anti-avoidance principles in order to disregard the non-commercial steps. An exemption applies for shares transferred between companies with a common shareholding of 90% or more (among other conditions). An application must be made to the Collector of Stamp Revenue to take advantage of the exemption.

Stamp duty must be paid before the transfer of shares can be registered in the books of the target company and within the time-periods specified in the Stamp Duty Ordinance.



## Deductibility of interest and financing costs

Availability of tax deductions for interest expense needs to be considered. Interest is only deductible in Hong Kong if it is incurred to derive assessable income, and is paid to either a bank or a lender liable to tax on the interest income.

If a Hong Kong holding company is used to acquire the Hong Kong target company and debt (whether shareholder or third-party) is injected at the holding company level to finance the buyout, to the extent that the investment in the target company does not generate any assessable profits for the Hong Kong holding company, the interest expense would be non-deductible. Therefore, since the dividends from the Hong Kong target company are exempt from tax, the deductibility of the financing costs is an issue in this case.

There are no thin capitalization rules for Hong Kong companies.

## Accumulated losses

Generally, it is possible for companies to carry forward losses for set-off in subsequent tax years. However, there are anti-avoidance provisions in the Inland Revenue Ordinance that allow the Commissioner to refuse to set off losses brought forward if he or she is satisfied that the sole or dominant purpose of a change in shareholding is the utilization of those losses to obtain a tax benefit. More due diligence is required if a target company has accumulated losses and a premium is sought for the benefit of the tax losses.

The fund may also seek an advance ruling from the Inland Revenue Department to confirm that the losses will remain available for set-off by the target company after the buyout.

## Withholding tax

Payments of interest or dividends by the Hong Kong target company to non-residents is not subject to any withholding tax as Hong Kong does not impose any withholding taxes on interest and dividends.

However, if the Hong Kong target company makes royalty payments to the non-resident fund for the use of intellectual property in Hong Kong (or for use outside Hong Kong if the payment is deductible against profits assessable in Hong Kong), the Hong Kong target company would be required to withhold tax. The amount of withholding tax is calculated as either 30% or 100% of the amount of profits tax payable on the payment (effectively 4.95% or 16.5% of the payment, based on the current profits tax rate of 16.5%). The higher rate applies if the intellectual property was previously owned in Hong Kong.

## Exit considerations

A key issue is whether the investment in the target company is regarded for tax purposes as being held as a trading asset or for long-term investment. As Hong Kong does not tax capital gains, this issue is particularly important. If the investment in the target company is regarded for tax purposes as being held for long-term investment, then the profits from the sale of the investment is not subject to Hong Kong tax. On the other hand, if the investment in the target company is regarded for tax purposes as being held as a revenue asset, the profits from the sale of the investment are assessable profits.

The issue of whether a profit is capital or revenue in nature is essentially a question of fact and depends on many factors including the intention of the taxpayer at the time of acquisition, and good documentation for the purpose of the buyout is essential to protect a tax position.

## 21. What forms of exit are available?

In solvent situations, the common forms of exit are via initial public offerings or trade sales to strategic investors or to another private equity firm.

In insolvent situations, the company may still be sold to another private equity firm or strategic investor if those parties believe that they can derive better value from the insolvent company. In certain situations, the insolvent company may be placed into voluntary or involuntary liquidation and any cash remaining after the creditors are paid is returned to shareholders.



## Hungary

### 1. What structures do private equity funds typically use to manage their funds?

Although the Hungarian market is considered to be part of the emerging private equity/venture capital market of the CEE region, only a few market players have a stable market presence in the CEE region. In practice, Hungarian private equity or investment funds are rarely used, and non-Hungarian funds are far more common. These are usually structured as limited partnerships.

Although the 2014 Collective Investment Vehicles and their Managers Act (**Collective Investment Act**) allows the establishment of a fund structure where each fund manages itself internally, externally managed funds (i.e., the fund manager and the fund are two separated legal entities) are more common in Hungary.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in Hungary?

The Collective Investment Act is the main law regulating private equity funds in Hungary. It was amended recently to implement the AIFMD<sup>11</sup> and the UCITS Directive<sup>12</sup>. The Collective Investment Act requires that collective portfolio management activities of investment fund managers be subject to prior official authorization of the Central Bank of Hungary (*Magyar Nemzeti Bank*) (**CBH**). Only investment fund managers may be authorized to perform investment management activities (decisions relating to investment strategies and asset allocation exercises in connection with the investment policy, including its implementation).

In addition, EU rules in relation to the so-called ‘passport regime’ (i.e., the marketing of shares or units of investment funds throughout the EU while being registered only in one member state) are also applicable to Hungarian investment funds. This means that an EU investment fund manager may market its funds’ shares or units directly to Hungarian investors without having registered funds in Hungary. Although marketing activities of the funds’ shares or units do not require a Hungarian investment vehicle *per se*, the fund or the fund manager (regardless of the member state of registration) typically establishes a Hungarian investment vehicle to undertake an investment.

Note also that the Investment Rules Government Decree (Government Decree No. 78/2014 (III.14)) (**Investment Rules Government Decree**) limits the amount of money a private equity fund (domestic or foreign) may invest in, or lend to, one single company to 40% of the registered capital of the private equity fund. On the other hand, the Collective Investment Act sets the minimum initial capital at HUF 250 million (approximately EUR 800 000). The subscribed capital of a private equity fund may be increased or decreased during the fund’s original term, but the registered capital may not drop below HUF 250 million under any circumstances.

### 3. Are there any approvals required for investments by foreigners in Hungary and, if so, what is the process?

Hungary has no exchange controls or mandatory foreign investment approvals of general application. Various approvals or notifications may be required in the case of acquisitions in certain fields, such as

---

<sup>11</sup> Directive 2011/61/EU of The European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010

<sup>12</sup> Directive 2009/65/EC of The European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)

financial services, utilities, and media sectors. However, those requirements exist principally because of the nature of the business concerned rather than as mechanisms to control foreign investment.

In a few exceptional cases, permission must be obtained from the competent authorities before the establishment of a business association (e.g., in relation to the financial services sector, which is regulated by the CBH). In these cases, the shareholders must sign the documents generally necessary for a company's establishment (e.g., articles of association, resolutions, etc.) and these documents, together with other documents prescribed by law, must be filed with the competent regulating authority. Then the permission together with other corporate documents must be filed with the Court of Registration (*cégbíróság*) within 15 days after the permission is obtained. Generally, Act XXIV of 1988 on the Investments of Foreigners in Hungary permits foreigners to engage in/conduct business activities in Hungary or to engage in business via a presence for business purposes in Hungary.

Hungary has signed the Convention on the Settlement of Investment Disputes between States and Nationals of other States (the Washington Convention) which aims to remove major impediments to the free international flow of private investment posed by non-commercial risks and the absence of specialized international methods for investment dispute settlement.

#### 4. Who are the relevant regulators in Hungary and how much interaction would one generally expect when undertaking a buyout?

The primary regulatory authorities in Hungary in a corporate context are:

- (a) the Budapest Stock Exchange (**BSE**);
- (b) the Central Bank of Hungary (**CBH**) - the financial supervisory authority;
- (c) the Hungarian Competition Authority (**HCA**) - the competition/antitrust regulator); and
- (d) the National Tax and Customs Administration of Hungary (**NTCA**) - the tax supervisory authority.

Once a private equity fund has been registered and authorized by the CBH, the CBH is entitled to monitor whether the fund consistently complies with the requirements of the Collective Investment Act and the Investment Rules Government Decree. Individual transactions are not monitored separately.

Interaction with the other authorities above largely depends on the nature and size of the transaction. For example, large transactions are likely to be notifiable to the HCA, and the level of expected involvement with the BSE in a buyout situation depends on whether the transaction involves a takeover bid.

#### 5. How are buyouts typically undertaken in the private and the public markets?

##### Private context

In a private context, transactions are usually undertaken by way of negotiated acquisition. That is, sale and purchase documents are prepared, negotiated and executed and those documents record the terms of the sale and acquisition and the rights and liabilities of the parties.



## Public context

In the public context, buyouts are generally concluded by way of a takeover bid. Broadly, the acquisition of:

- (a) more than 25% of the target company's voting rights, where no shareholder (other than the bidder) holds more than 10% of the voting rights; or
- (b) the acquisition of more than 33% of the target company's voting rights,

must be performed via a mandatory public takeover bid, which must be approved by the CBH in advance.

The Capital Markets Act sets out the content requirements of the offer documentation (e.g., it must include the deadline of the validity of the takeover bid, a description of the bidder's relationship with the target company and the percentage of the direct/indirect ownership interest). Any offer document the terms and/or operation of which is contrary to the principle of equal treatment among the target company's shareholders is considered to be unlawful.

The CBH decides on the approval of a takeover bid within 10 working days from the date of filing. The CBH has no discretion not to approve the takeover bid if the offer complies with the provisions of the Capital Markets Act.

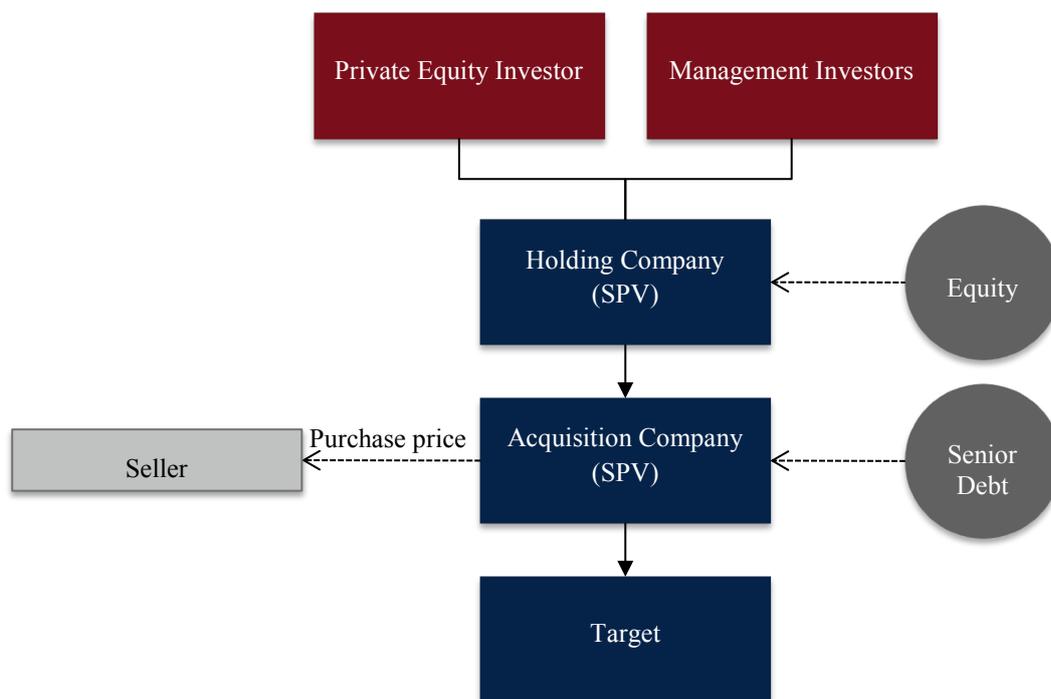
After receiving approval from the CBH, the bidder must immediately publish the offer (which must state the time period within which a declaration of acceptance may be made). The Capital Markets Act contains detailed rules in relation to the purchase price, and the bidder is only entitled to increase the purchase price of the shares set out in the offer (i.e., the bidder is not entitled to offer a lower price from the price set out in the offer). The takeover bid must apply to all voting shares of the target company and be presented to all shareholders having voting rights.

The articles of association of a company may include a provision that prohibits management from adopting any decision that aims to defend the company against a bidder acquiring the target company's shares (e.g., increase of share capital and buying up own shares). If that provision is included in the target company's articles of association, management is prevented from seeking to defend against the takeover bid. If, however, the target company's articles of association do not contain this type of provision or the general assembly empowers management to perform a takeover defense, then management may prevent the bid.

Finally, in public transactions, it is standard practice, once a majority shareholding in a listed company is acquired, for the company to be de-listed from the BSE and converted into a private entity.

## 6. What is the typical corporate structure used when doing a buyout?

Corporate structures vary from transaction to transaction; however, the purchaser often sets up a two-tier acquisition structure as follows:



Non-Hungarian private equity fund managers or funds typically realize their investments via Hungarian investment vehicles (i.e., the foreign fund incorporates a local special purpose acquisition company as the acquisition vehicle in relation to a buyout (Acquisition Company SPV).

Senior debt finance is usually provided to the Acquisition Company SPV, while the equity contribution from the private equity fund or funds is contributed at holding company level and then contributed down to the Acquisition Company SPV in the form of an unsecured loan, funds or equity.

More elaborate structures exist on larger, more complex deals, particularly if any debt funding involves mezzanine funding sources that may need to be structurally subordinated to the senior financiers but rank ahead of any equity contributed by the private equity fund or funds.

For the local Acquisition Company SPV, usually one or more of the following Hungarian corporate entities are adopted:

- limited liability companies (*korlátolt felelősségű társaság*)(**Kft**);
- private companies limited by shares (*zártkörűen működő részvénytársaság*)(**Zrt**); or
- public companies limited by shares (*nyilvánosan működő részvénytársaság*)(**Nyrt**).

## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

#### *Private companies*

For a buyout negotiated in a private context the primary legal document that records the transaction is the sale and purchase agreement. There may also be other ancillary transaction documents prepared



depending on the nature of the deal. These can include an escrow agreement and a shareholders agreement.

#### *Public companies*

For a buyout in a public context the primary legal document is a takeover bid (public offer) for the outstanding shares (as described in the answer to question 5).

## Banking

#### *Lending documents*

The main banking document is the senior facilities agreement under which the senior debt facilities (typically amortizing and non-amortizing term loans with working capital lines and in some instances capital expenditure or acquisition facilities) are documented. If the financial assistance rules allow the target company to grant security, lenders usually also request the target to grant security over its assets (subject to the closing of the acquisition).

If there is subordinated and/or mezzanine debt, there is typically a separate facility agreement under which that debt is made available and an intercreditor or subordination deed recording the respective rights of the senior and subordinated/mezzanine lenders.

#### *Security*

Security is usually held by all lenders and primarily managed by a security agent for the lenders.

Security typically comprises a mortgage over real estate, a share pledge, a bank account pledge, a security assignment of revenues, and a charge over all of the assets of the target company. Further, the lenders also usually require a sponsor's undertaking from the holding company to invest the required equity and to cover any financial shortfalls related to the acquisition.

#### *Other*

Fees are usually recorded in a separate letter rather than in the main facilities agreement.

Hedging is generally always documented in an ISDA (International Swaps and Derivatives Association) multi-currency master agreement.

## 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

### Private companies

In a private context, buyer protections usually take the form of negotiated warranty and indemnity coverage from the seller (being either the shareholder(s) in a share deal or the company from which the business and assets are being acquired). The terms of that coverage vary from transaction to transaction. However it is quite usual to expect that limits are set in relation to the coverage, including claim thresholds and caps, time limits and adjustments for items otherwise disclosed or accounted for. More recently, as auction processes have become more sophisticated, buyers have also sometimes sought warranty and indemnity insurance or the placement of a portion of the sale proceeds in escrow for a period.

### Public companies

In a public context, the level of buyer protection which can be obtained is less than in a private context. The primary form of protection usually takes the form of conditions precedent to the acquisition that either need to be satisfied or not triggered. Warranty protection from target shareholders is very limited and generally only extends to confirmation in relation to unencumbered title and due authority to sell.

## 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

No specific law exists regulating conflict of interest issues in a typical management buyout.

The Civil Code imposes general statutory obligations on the executive officers of a company to carry out their duties and to act in the best interests of the company, to keep the business secrets of the company and not to use the information of the company improperly to their own advantage, among others.

In practice, it is usual that members of the management team who are participating in a buyout are excluded from participating in any internal discussions and decision-making procedures in relation to the buyout. This arrangement is usually not implemented in any specific form or document. Rather, it is typically agreed informally among the members of management and/or the shareholders.

## 10. How are the equity arrangements typically regulated in a buyout?

The equity arrangements in a buyout are usually regulated by a shareholders agreement. Additionally, the target company's articles of association may include specific share rights attaching to the relevant classes of security to be issued.

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

There is a great deal of flexibility under Hungarian law in relation to the types of equity security that can be issued and the level of rights tailoring that can occur. Various classes of preference shares may be issued. These include:

- (a) shares affording preferred dividends;
- (b) liquidation preferences;
- (c) preferences relating to voting rights;
- (d) the right to appoint or remove management or supervisory board members; and
- (e) pre-emption rights.

It is common to see different classes of security issued to management and the private equity fund in a buyout.

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

### General

Generally, issues regarding board constituency, differential director voting rights, as well as appointment and removal of directors are governed in the relevant shareholders agreement, the articles of association and, in some instances, in the bylaws of the board of directors. Note that the articles of association must be filed publicly.

Managing directors and board members may be natural persons or legal entities. The natural persons may be either foreign or Hungarian residents (so it is possible to establish an all-foreign board). However, if the managing director or the board member has no Hungarian address, a service agent (located in Hungary) must be appointed and also registered in the trade registry.



It is common for private equity funds to have specific appointment and removal rights in respect of a certain number of directors on the boards of their portfolio companies and for their voting rights to be aggregated where a director is absent from a meeting.

## Board composition

### *Limited liability company (Kft and Zrt)*

A Kft must have at least one managing director. The managing directors may represent the company either individually or jointly, whereas a Zrt is managed either by the board of directors consisting of a minimum of three members (i.e., directors) unless the shareholders decide to appoint a CEO, in which case no board of directors is required.

### *Public company (Nyrt)*

An Nyrt may be managed in the form of either a one-tier or a two-tier system.

In the case of a one-tier system, the company is managed by the management board of directors consisting of a minimum of five members, the majority of whom must be independent. A board member would not be considered independent, for instance, if:

- (a) the board member is a shareholder directly or indirectly controlling at least 30% of the votes of the company, or a close relative or significant other (partner) of that shareholder;
- (b) the board member is a close relative or significant other (partner) of any non-independent executive officer or executive employee of the company;
- (c) the board member is entitled to receive financial benefits based on his board membership if the company operates profitably, or receives any other form of remuneration from the company apart from the salary for his or her board membership, or from an affiliate of the company; or
- (d) the board member has a legal relationship with another non-independent member of the board in another company based on which the non-independent member attains control or supervision.

If a two-tier system is selected, the company is managed by the board of directors (comprised of at least three members) that, in turn, is supervised by a supervisory board that is responsible for protecting the interests of the company. The supervisory board must also consist of at least three members.

## Differential director voting rights

Differential director voting rights are not expressly regulated by Hungarian company law. However, in practice, there are some boards of directors that operate using differential director voting rights, although this is not common. It is advisable to determine the specific terms of differential voting rights in the articles of association and also in the bylaws of the board of directors.

### **13. What measures are commonly used to give a private equity fund some level of control over key operating and financial decisions made by a portfolio company?**

It is usual for control over key operating and financial decisions made by a portfolio company to be enshrined in the shareholders agreement or the articles of association of the portfolio company. These control rights typically include:

- (a) the right to appoint one or more directors on the board of the portfolio company;

- (b) rights to receive financial and operating information on a regular basis; and
- (c) specific consent or veto rights over particular decisions of the portfolio company, including decisions that relate to operating or financial matters.

#### **14. What employment terms are generally imposed on management in a buyout?**

It is common for senior members of a management team in a buyout to enter into an executive services agreement. Generally speaking these agreements do not provide any fixed employment period, but include provisions dealing with the period of notice that must be given before the employment can be terminated. This period is a matter of negotiation and commonly varies depending on the seniority of the relevant manager. It is also common for remuneration under these agreements to include a fixed component and a bonus component referable to performance.

Equity incentives offered to management are almost invariably covered in the shareholders agreement rather than in the executive services agreement.

#### **15. What equity incentives can be offered to management and how are they typically structured?**

There is a great deal of flexibility in relation to incentives offered to management.

##### **Equity**

These incentives generally take the form of ordinary equity or options over ordinary equity. It is also possible to create forms of phantom equity, but careful planning of these phantom equity plans is required. Management is expected to pay for its equity, although by reason of the leverage provided by the private equity fund, the contribution rate for its capital is preferred over the rate contributed by the private equity fund.

##### **Ratchet mechanisms**

It is not uncommon for management to be offered a ratchet in relation to its equity which operates to give it a greater overall return if the investment for the private equity fund outperforms certain base return thresholds (usually measured by reference to the fund's internal rate of return on the investment or an absolute money multiple). Generally these ratchets only finally crystallize once the fund has achieved a full exit of its investment.

##### **Equity plans**

In certain cases, management equity plans are adopted to regulate the way in which management equity is issued, which can include earning or vesting of the equity over a period subject to achievement of agreed financial hurdles, and can be re-acquired by the portfolio company if a manager ceases to be employed for any reason. Good leaver and bad leaver provisions are very common (either in the shareholders agreement or the terms of the relevant plan) and effectively give the portfolio company (or its other shareholders) the right to acquire the equity at a pre-determined price in a leaver situation.

#### **16. How are buyouts typically debt financed and secured?**

##### **Lending**

While it varies from transaction to transaction, up to 70-80% of the cost of an acquisition may be provided from debt provided by banks and financial institutions, if the loan-to-value ratio is also in that range. The amount of debt that can be raised is typically calculated as a multiple of the earnings of the target business.



Lenders usually expect the equity to be structurally subordinated to the debt finance with the debt being lent to a special purpose company that is a wholly-owned subsidiary of the holding company.

## Security

Security may be comprised of:

- (a) mortgages over real estate;
- (b) share pledges;
- (c) bank account pledges;
- (d) an assignment of revenues; and/or
- (e) charges over all of the transaction special purpose vehicles, and (subject to compliance with the financial assistance provisions of the Civil Code), the target companies.

The target companies may also be required to cross-guarantee their obligations to the bank lenders.

## 17. Are there financial assistance issues to consider when undertaking a buyout?

Hungarian law prohibits the giving of financial assistance in relation to the acquisition of shares issued by an Nyrt except on certain conditions.

Under Section 3:227 (1) of the Civil Code:

‘Public companies limited by shares shall be allowed to provide financial assistance to third parties for the acquisition of shares issued by the public limited company only:

- (a) under market conditions;
- (b) from the assets available for the payment of dividends; and
- (c) provided that the general meeting approved such decision by at least a three-quarters majority upon recommendation by the management board.’

Section 3:227 (2) of the Civil Code sets out in detail the rules that apply to the recommendation of the management board (i.e., the requirements of the ‘whitewash procedure’ under Hungarian law). It states:

‘The recommendation shall contain:

- (a) the reasons for the financial assistance;
- (b) the risks involved;
- (c) the conditions;
- (d) the price of the shares; and
- (e) the advantages the company is likely to gain by providing such financial assistance.’

These requirements came into effect on 15 March 2014. They are applicable to an Nyrt if the company has amended its articles of association and recognized the corporate rules of the Civil Code as binding on it. Because the rules have come into effect very recently, there is not yet an established court practice nor any relevant commentary nor guidelines in relation to the application of the above financial assistance rules.

In relation to other types of companies, in particular the Zrt and the Kft by quotas, we are not aware of any distinct rules in relation to the prohibiting or limiting of the giving of financial assistance.

## 18. What are the implications under the corporate benefit laws of Hungary for a company providing financial assistance?

Hungarian law does not recognize the concept of corporate benefit in the common law sense.

Nevertheless, under Section 3:112 (2) of the Civil Code:

‘The executive officer shall manage the operations of the business association independently, based on the primacy of the business association’s interests. In this capacity, the executive officer shall discharge his duties in due compliance with the relevant legislation, the instrument of constitution and the resolutions of the company’s supreme body.’

Therefore, the executive officers of any company must act in the best interests of that company. In limited circumstances, however, if there is an imminent threat to the business association’s solvency, the executive officers must take the creditor’s interests into account. An imminent threat to the business association’s solvency has occurred when the executive officers of the company were or should have been able to foresee that the business association will not be able to satisfy its liabilities when due.

Under Section 3:118 of the Civil Code:

‘In the event of a business association’s dissolution without succession, creditors may bring action for damages up to their claims outstanding against the company’s executive officers on the grounds of non-contractual liability, should the executive officer affected fail to take the creditors’ interests into account in the event of an imminent threat to the business association’s solvency. This provision is not applicable in the case where the company is wound up without going into liquidation.’

Therefore the giving of financial assistance is limited by it being able to be given, in the opinion of the management board, without making the company insolvent.

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

Typically, in any external administration (i.e., liquidation procedure) of a company, the secured creditors rank ahead of the unsecured creditors and the unsecured creditors rank ahead of the shareholders. The debts of the company are satisfied in the following order:

- (a) liquidation expenses;
- (b) claims secured by floating charge established prior to 15 March 2014, and a charge established on the entire assets of the debtor after 15 March 2014, up to the value of the pledged property (note that notwithstanding this order of priority, 50% of the income received from the sale of the assets less the costs of sale will be used exclusively to satisfy the claims secured by the floating charge/charge established over the entire assets of the debtor);
- (c) alimony and life annuity payments, compensation benefits and income supplements to miners which are payable by the debtor and monetary aid granted to members of agricultural cooperatives in lieu of household land or produce, to which the beneficiary is entitled for his or her lifetime;
- (d) with the exception of claims based on bonds, other claims of private individuals not originating from economic activities (in particular claims resulting from insufficient performance or compensation for damages, also including the amount of the guarantee



- obligations ordinarily expected in the given trade, as calculated by the liquidator), claims of small and micro companies as well as small-scale agricultural producers;
- (e) outstanding social insurance payments and overdue private pension fund membership dues, taxes and public debts collectable as taxes, repayable government subsidies, as well as water and sewage utility charges;
  - (f) all other liabilities which are not covered in the list above;
  - (g) irrespective of the time and grounds of occurrence, default interest and late charges, as well as surcharges and penalty and similar debts;
  - (h) claims (other than claims for the payment of wages and other similar employment benefits, if the total amount of the claim does not exceed six months' average salary and the amount of the concerned person's salary does not reach double the amount of the statutory minimum wage) held by:
    - (i) any member (shareholder) of a debtor with majority control;
    - (ii) any executive officer of the debtor;
    - (iii) any executive employee of the debtor;
    - (iv) the close relatives of the persons listed in (i)-(iii) above;
    - (v) a company under the debtor's majority control; or
    - (vi) a body (person) benefiting from the debtor's gratuitous commitments.

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

The Hungarian tax and stamp duty issues that need to be considered on a buyout are set out below.

### Stamp duty/transfer taxes

Generally, share (quota) acquisitions are exempt from VAT and transfer tax. However, the acquisition of shares of a company holding real estate is subject to transfer tax under certain conditions. Transfer tax is payable if the acquirer of the shares owns, directly or indirectly, at least 75% of the total of the shares of a company, in which in that company's balance sheet the value of real estate located in Hungary is more than 75% of the total value of assets (**Real Estate Holding Company**). The total number of shares includes shares held by related parties and close relatives of the acquirer as well as close relatives of those related parties. The tax base is the proportional part of the market value of the Hungarian real estate increased by the proportional value of the real estate its affiliate Real Estate Holding Company owns. The tax rate is 4% up to a market value of HUF 1 billion, plus 2% on any excess over this value, with tax payable capped at HUF 200 million per real estate.

Transfer tax may apply on some transferred assets, especially on real estate, pecuniary rights attached to real estate (e.g., rights to use the real estate) and the transfer of motor vehicles.

The transfer of real estate and rights related to it is subject to transfer tax on the basis of the market value of the real estate. The general rate of transfer tax is 4% (up to a market value of HUF 1 billion) and 2% (on the excess above this value), with tax payable capped at HUF 200 million per piece of real estate. A special 2% regime is applicable if a piece of real estate is acquired by a real estate agent or a financial leasing company. In the case of pecuniary rights attached to real estate, the basis of transfer tax is 1/20th of the market value (not reduced by any encumbrances on the real estate) multiplied by the number of years of the existence of the right (e.g., usufruct rights).

If certain conditions are met, a so-called ‘preferential’ transfer of assets is exempted from transfer tax. A preferential transfer of assets is a transaction by which a company (the transferor) transfers one or more independent branches (or lines) of its activity to another company (the transferee) in exchange for quotas or shares representing the capital of the transferee (and the transferor is not dissolved).

### Thin capitalization rules

If the acquisition is financed through debt, Hungarian thin capitalization and transfer pricing rules should be considered. According to the Hungarian thin capitalization rules, the maximum debt/equity ratio is 3:1, meaning that the amount of interest attributable to the debt exceeding the 3:1 ratio is not deductible for corporate income tax purposes. Debt from financial institutions must not be taken into account for the purposes of the calculation.

### Withholding tax

Under Hungarian law, no withholding tax is payable on dividends or interest paid to non-resident entities.

### Income tax consequences of an exit

The Hungarian income tax consequences of any exit must be carefully reviewed. Key issues include the application of Hungarian income tax on any sale.

#### *Sale of shares*

Any profit made by a resident company on the sale of shares is accounted for as a part of the corporate income tax base. If the tax base is positive, it is subject to corporate income tax at a rate of 10% (up to a tax base threshold of HUF 500 million) and 19% above that level.

However, certain exemptions may apply. For example, if an entity acquires at least 10% of the shares of a company (except a controlled foreign company), and declares the acquisition to the tax authority within 75 days from the acquisition, the shares will be considered to be shares declared to the tax authority. Any profit made on the sale of shares declared to the tax authority is exempt from corporate income tax, provided that the company held the shares for more than one year.

#### *Sale of assets*

Any profit made by a resident company on the sale of assets is accounted for as a part of the corporate tax base. If the tax base is positive, it is taxed as it is described under the above paragraph ‘Sale of shares’.

Generally, the sale of assets by a corporate non-resident is exempt from income taxes. However, any gain realized by a non-resident company on the disposal of assets forming part of a Hungarian private equity fund is forming part of the corporate income tax base, and taxable in Hungary as it is described under the above paragraph ‘Sale of shares’. The same applies in relation to any gain realized on the disposal of Hungarian real estate, provided that the relevant double taxation treaty allows it.

### Capital gains tax

Hungarian income tax law includes a number of specific tax concessions aimed at promoting venture capital investments (e.g., there are capital gains tax (CGT) exemptions that apply if, for example, certain conditions as described above under ‘Sale of shares’ are met).

For Hungarian tax resident individuals, capital gains include gains realized on a sale of shares, and are uniformly subject to a flat 16% rate of personal income tax.



Generally, for non-residents the sale of shares is not subject to CGT unless the shares are of a company real estate holding in which case the capital gains realized are subject to personal income tax at a rate of 16%. A Hungarian company qualifies as a 'real estate holding company' if:

- (a) on the balance sheet, the book value of the Hungarian real property of the company and its affiliates represents more than 75% of the total book value of their assets; and
- (b) the company (or an affiliate of the company) has a shareholder that is a Hungarian tax resident on at least one day of the relevant tax year, in a country with which Hungary does not have a double taxation treaty or the relevant double taxation treaty makes the taxation of capital gains in Hungary possible.

A company traded on a regulated stock exchange does not qualify as a 'company holding real estate'.

### Tax at the level of the investment units

As of 1 January 2015 the distributors and the investment funds are subject to a special (collective investment units) (CIU) tax, levied at the annual rate of 0.05% of the tax base.

The new type of tax is imposed on:

- (a) foreign collective investment securities kept on securities accounts and distributed in Hungary by a distributor; and
- (b) investment notes of an investment fund registered in Hungary and managed by an investment fund manager.

The 'tax base' is:

- (a) in the case of the distributors, the value of the foreign collective investment securities of the clients (excluding the value of the investment securities owned by the CIU) expressed in HUF and calculated as the net asset value of the purchased securities in a given quarter divided by the number of calendar days of the quarter; and
- (b) in the case of the investment funds, the value of the investment notes of the investment funds managed by the investment fund manager (excluding the value of the investment notes owned by the CIU) calculated as the net asset value of those investment notes in a given quarter divided by the number of calendar days of the given quarter.

### Tax at the level of the individual owners of the investment units

On an exit, if the CIU is considered to be a 'controlled foreign company' (CFC), capital gains are considered to be 'other income', and as such, they are subject to personal income tax at a rate of 16% as well as a healthcare contribution at a rate of 27%, without a cap. This results in an effective tax rate of 43%. Capital gains, including the gains realized on a sale of shares, are uniformly subject to a flat 16% rate of personal income tax. Capital gains also are subject to a 14% healthcare contribution which is payable by the individual receiving the capital gains.

Furthermore, if an individual's direct or indirect participation or voting rights in a CFC reach 25% (participation or voting rights of close relatives has to be added), then the individual has to pay 16% personal income tax and 27% healthcare contribution on the undistributed profit of the CFC falling on the participation of the individual. The CFC's after tax profit less the paid dividend is considered to be undistributed profit.

In general terms, a foreign company is considered to be a CFC, if:

- (a) there is a beneficial owner who is considered a Hungarian resident under the Personal Income Tax Act; or

(b) the major part of the company's revenues in a given tax year originates from Hungary, provided in either case ((a) and (b)), that the tax paid by the company is less than 10% of the tax base or the company did not pay any tax equivalent to corporate tax due to a zero or negative tax base, even though it made a profit.

Further, in respect of CFCs, any capital gains tax payable abroad can be credited against tax payable in Hungary, but, in the absence of an international agreement, tax at a minimum 5% rate must be paid on the capital gain.

## 21. What forms of exit are available?

Typically a private equity investor exits its investment via a trade sale. It is also not uncommon for private equity funds to achieve a return on their investment during the life of the investment by undertaking a leveraged recapitalization. In that case, the return can take the form of a dividend and/or some other form of capital distribution or buy back. IPOs as an exit route are not common in Hungary.



## Indonesia

### 1. What structures do private equity funds typically use to manage their funds?

Private equity funds do not have to establish any specific entity in Indonesia in order to conduct their activities.

As a result, private equity funds typically hold their Indonesian investments through companies set up in a country that enjoys tax treaty exemptions or benefits with Indonesia, (e.g. Singapore and, to a lesser extent, Hong Kong and the Netherlands), in order to allow for the payment of any dividend, interest or fees at the most beneficial tax rates. Care needs to be taken however given that tax regulations can, in certain instances, look through special purpose vehicle structures and attribute liability to ultimate owners or other shareholder entities with substance.

Tax haven jurisdictions have also been used in the past (largely for anonymity issues, which may be less relevant moving forward given recent developments in this area), although Indonesia has no double taxation treaties in place with BVI or Cayman Islands.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in Indonesia?

Indonesia has no specific regulatory oversight directed at private equity funds. Indeed, no differentiation is made between sophisticated and non-sophisticated investors, meaning that all investors (including private equity funds) are deemed to be the same and are subject to the same regulations. This typically results in investments being made through off-shore incorporated entities.

Indonesian limited liability companies can be registered as investment managers (being managers of security portfolios for customers or collective investment portfolios for a group of customers) or venture capital companies (being companies that provide financing to, or conduct share participation in, an investee for a limited period), both being regulated by the Financial Services Authority (**OJK**) (the umbrella authority regulating the financial services sector). Very few companies, and no major private equity funds, are registered as venture capital companies to date, given the prescriptive requirements that need to be met.

### 3. Are there any approvals required for investments by foreigners in Indonesia and, if so, what is the process?

#### Foreign investment and approvals

Most private foreign investments in Indonesia (and domestic investments enjoying the same facilities) are administered and supervised by the Indonesia Investment Coordinating Board (**BKPM**). Consequently, most matters relevant to M&A transactions must be reported to or approved by BKPM.

All foreign investments in Indonesia are subject to potential restrictions as set out in the so-called 'negative list', a Presidential Regulation setting out those business sectors restricted (either fully or partially) in relation to foreign participation (**Negative List**). It may also set out further conditions associated with particular business sectors, such as obligations for Public-Private-Partnerships, although typically these types of further conditions are set out in applicable regulations (often sector specific) that must also be complied with in addition to the Negative List.

To the extent that a relevant business field is not included in the Negative List, the principle is that it is open to 100% foreign participation. The Negative List is comprehensive in nature and covers a wide range of business sectors, including specialist hospitals (open to 70% foreign participation for ASEAN investors or 67% for all others), wired telecommunication services (open to 65% foreign

participation) and distribution (open to 33% foreign participation). The Negative List was intended to be updated every three years (although this requirement was removed in the most recent update in 2014).

The Negative List only applies to ‘direct’ investments and does not apply to ‘indirect/portfolio’ investments made through the Indonesian Stock Exchange (**IDX**). While no guidance is given in relation to what constitutes ‘direct’ or ‘indirect/ portfolio’ investments, any controlling interest is not considered to be a portfolio investment.

## PMA Companies

Any non-listed company accepting foreign capital must be in the form of a foreign investment company (known as a **PMA Company**). Ownership of capital in a PMA Company is subject to the approval of the BKPM. If all requested documents are provided and the proposed investment does not breach foreign investment restrictions, approval is usually issued within 10 working days. It is necessary to return to BKPM to obtain approvals in the case of any subsequent increases or issues of capital.

## Change of control

There is a set process under Indonesian Company Law (**Company Law**) for a change in control of an Indonesian company. A broad concept of change of control is applied, but generally any one shareholder ceasing to hold at least 50% of equity or moving from a minority position to holding at least 50% of equity is a change of control. Any change of control requires a 30-day creditor and employee notification procedure prior to the ‘calling’ of the general meeting of shareholders authorizing the transfer or issue of shares leading to the change of control.

## Sector specific approvals

Further sector specific approvals (such as from the Ministry of Telecommunications in the case of certain telecommunication investments or the Ministry of Agriculture in the case of acquisitions in the plantations sector) may be required depending on the sector, and timing can vary widely to obtain these approvals. These approvals would need to be considered at the outset because approvals may cause delays to the completion timeline. Indonesia is a highly regulated jurisdiction and sector specific approvals and licensing requirements can be both time consuming and administratively burdensome.

## Public market transactions

Public market transactions fall under the supervision of the OJK and, depending on the structure, the OJK may be required to give an effective letter for a transaction to proceed. A portfolio purchase on the Stock Exchange does not require OJK approval.

## 4. Who are the relevant regulators in Indonesia and how much interaction would one generally expect when undertaking a buyout?

Relevant regulators include:

- (a) Ministry of Law and Human Rights (**MOLHR**) - this Ministry has an umbrella role covering a broad spectrum of legal affairs in Indonesia. In relation to corporate matters the MOLHR will be responsible for approving, among others, any issuance of shares and a company’s articles of association (including any subsequent amendments). As such, MOLHR approval of the capital structure of a company, including rights associated with any share classes or any preferential shareholder rights, is required. All share transfers also have to be notified to the MOLHR, however notification occurs following the legal effectiveness of the transfer and does not involve a separate approvals process;



- (b) Investment Coordinating Board (*Badan Koordinasi Penanaman Modal*) - (**BKPM**) - which has authority in relation to foreign investment in Indonesia. BKPM is currently rolling out a 'one stop shop' policy by which it will coordinate all licensing requirements relating to an investment (which is currently handled by separate ministries depending on the sector), although the extent of this reform in practice is currently unclear;
- (c) Financial Services Authority (*Otoritas Jasa Keuangan*) (**OJK**) - an umbrella authority to regulate and supervise activities in the financial sector including banking, financial markets, insurance and re-insurance, pension funds, financing institutions and other types of financial service institutions. It is relatively new (having assumed duties at the end of 2012) and has taken over several regulatory and supervisory authorities previously held by Bank Indonesia and the Capital Market and Financial Institution Supervisory Body (*Bapepam*) (LK);
- (d) in addition to the OJK as the regulatory and supervisory authority, the Indonesian capital market also recognizes three self-regulatory organizations as corporations with particular authority and rule-making capacities, namely the Indonesian Stock Exchange (**IDX**) (applying various IDX rules and regulations), the central securities depository (KSEI) and the clearing and guarantee institution (KPEI); and
- (e) Business Competition Supervisory Commission (*Komisi Pengawas Persaingan Usaha*) (**KPPU**) - Indonesia's competition authority. Uniquely, Indonesia currently applies a mandatory post-completion approvals process in cases where certain financial thresholds are met (although it is possible to conduct a non-binding pre-completion consultation in instances where competition concerns have been identified). Proposals exist to move to a pre-completion approvals regime, so further reform in this area is likely.

## 5. How are buyouts typically undertaken in the private and the public markets?

### Private companies

In relation to private companies, a buyout is generally undertaken by way of a private acquisition that concludes after negotiations between the parties (whether by a bilateral deal or through an auction process). The parties negotiate and execute a sale and purchase agreement that records the terms and conditions of the acquisition as well as the rights and liabilities of the parties involved.

### Listed companies

In relation to public listed companies, a buyout is typically undertaken by negotiating a share purchase with the controlling shareholders, followed by a mandatory (general) offer. The tender offer statement must contain, among other things, the following information:

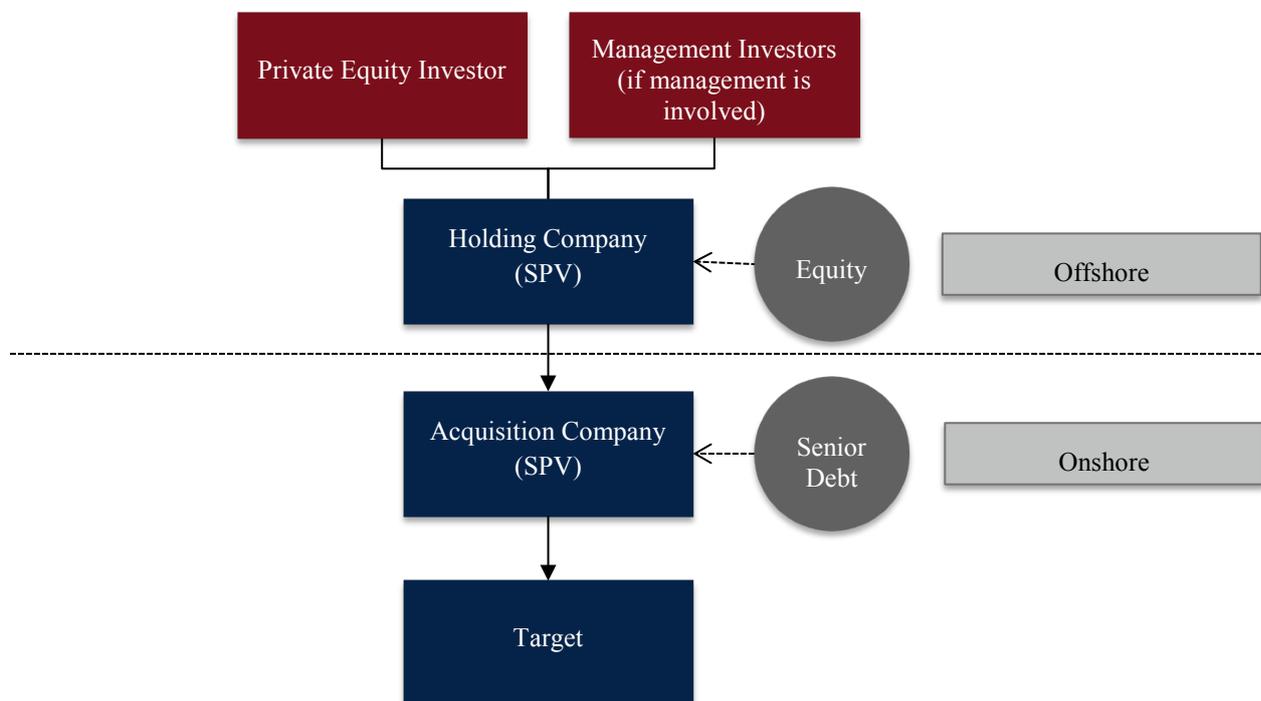
- (a) the identity of the target company;
- (b) information about the shares subject to the tender offer;
- (c) the identity of the party making the tender offer;
- (d) the requirements and special conditions of the tender offer;
- (e) the number of equity securities of the target company that the party making the offer already owns; and
- (f) a statement by an independent accountant, bank or underwriter that the party has adequate funds to finance the offer.

The above information must be published in at least two Indonesian daily newspapers (one of which must have national circulation) on the same date that the offer is submitted to the OJK. The tender offer period must last for at least 30 days and can be extended for up to 90 days.

## 6. What is the typical corporate structure used when doing a buyout?

Funds typically undertake a buyout through an offshore investment company incorporated in a jurisdiction that allows for double taxation treaty protection (provided substantive tests can be met). More elaborate structures are used on larger and more complex deals.

The most common structure is:



## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

Typically, before negotiations begin for a buyout, the investor and the target company sign a confidentiality agreement.

Negotiation usually begins with the circulation of a term sheet or memorandum of understanding that is a summary of points agreed, or to be agreed, between the investor and the company.

After due diligence in relation to the target company is completed, the share purchase agreement, subscription agreement or investment agreement is executed by both parties. Typically, a shareholders agreement is also entered into by the investor, the target company and existing shareholders of the target company if the company is not wholly acquired.

Some other relevant documents that may be prepared when undertaking a buyout include employment agreements between key employees and the target company, an employee share option plan and management or service agreements.



## Banking

The main banking document is the facilities agreement under which the terms of the loan made to the target company are documented. Typically, separate security documents are executed by which the target company provides security for the loan granted to it (subject to any corporate benefit issues being satisfied). The nature of the security depends on the circumstances.

If there are different debt providers, their relative positions depend on subordination and other contractual arrangements negotiated between the parties. Where there are different types of debt finance, subordination is typically implemented through an intercreditor agreement.

### 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

A private equity fund usually seeks a full range of warranties and indemnities from the sellers and management as a form of buyer protection when undertaking a buyout. Warranties sought are consistent with those typically found in other markets, although investors may seek more comprehensive warranties in relation to issues such as corporate governance, licensing and compliance than may be typical in more mature markets. Part of the purchase consideration may be withheld or placed in escrow for a fixed period to meet any warranty or indemnity claim.

Conditions precedent (including in relation to Indonesian regulatory consents) that need to be fulfilled by completion are also included. These conditions may include pre-completion restructuring or compliance requirements (especially if non-compliance has been identified as part of due diligence findings) and employment contracts with key employees.

### 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

There are no specific laws regulating how conflicts of interest are to be managed in a typical management buyout.

However, the Company Law does impose general statutory obligations on directors to act with good intention and 'in a full sense of responsibility'. There is very little guidance (judicial or otherwise) in relation to the scope of this obligation (although case law is often unrecorded in Indonesia and, as a civil law jurisdiction, does not form precedent in any event). As provided for in the Company Law, directors cannot vote if there is a conflict of interest (and may be deemed to be personally responsible for any losses to the company if they vote where there is a conflict of interest).

For public listed companies, the relevant OJK rules provide that any transaction where there is a difference between the economic interests of a public company and the personal interests of its directors, commissioners (Indonesia having a two-tiered board structure with the board of commissioners having a supervisory role) or principal shareholders must be approved by the independent shareholders in a specially convened shareholders' meeting.

Similarly, affiliated party transactions (being transactions between the public company and its directors, commissioners, principal shareholders or their affiliates) must be disclosed to the OJK and supported by a fairness opinion (which must be notified to the OJK and disclosed to the public).

### 10. How are the equity arrangements typically regulated in a buyout?

The equity arrangements in a buyout are typically regulated by a shareholders agreement entered into by the existing shareholders of the company and the new investors. The articles of association of the company will typically also be amended to reflect the shareholders agreement (although Indonesia offers limited ability to structure preference shares as may be typical in other jurisdictions as discussed in the answer to question 11).

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

The Company Law allows for a company to issue different types of shares, such as voting shares, non-voting shares, redeemable shares and shares with certain voting rights, among others, although, as a matter of policy, approval of different classes of shares (e.g., non-voting shares) is not necessarily always given by the MOLHR.

Preference share structures are relatively uncommon in Indonesia. There are no detailed provisions under the Company Law dealing with redeemable preference shares and their specific distinguishing characteristics, as is typically found in common law company legislation. The key issue is that the ability to redeem shares must follow the share buyback procedures under the Company Law, which are restrictive or occur by way of a capital reduction.

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

A two-tiered board structure, being a board of directors and a board of commissioners, applies in Indonesia. The board of directors has responsibility for day-to-day activities while the board of commissioners provides a supervisory function. The approval of the commissioners is required for specific matters mandated by the company law, the articles of association and the OJK. It is possible to appoint only one member to each board (but the same person cannot be appointed to both boards).

Typically the shareholders agreement sets out the relationships, rights and obligations among the investor, the target company and the existing shareholders of the target company. The shareholders agreement and the articles of association would govern matters concerning board constituency, restricted director voting rights and the removal of directors. Directors and commissioners each have one vote, and there are no differential directors' voting rights *per se*.

There is no provision in the Company Law that prescribes the manner in which directors are to be appointed, although this is typically by way of shareholder approval. There are certain exceptions for specific groups of people (e.g., undischarged bankrupts or individuals sentenced in relation to certain crimes) that are not allowed to hold directorships. The appointment and removal of directors is usually left to the company's articles of association. If, however, a director or commissioner is to be removed there is a set process under which the person is entitled to defend themselves at a shareholders' meeting.

## 13. What measures are commonly used to give a private equity fund some level of control over key operating and financial decisions made by a portfolio company?

The fund usually has representation on the board of directors and board of commissioners of the company if it wishes to have a say in the management and direction of the company. Representation on the board may also include a presence on the audit, compensation or similar committees. In this regard, a shareholders agreement or the deed of establishment/articles of association of a company can entrench the fund's right to appoint a majority of members to the boards for private limited companies.

The fund may create particular corporate governance and approval authority workflows to impose restrictions on the management in undertaking any fundamental matters (such as a major acquisition or disposal) or large projects without board or shareholder approval.

For public companies, being able to control boards or operating decisions means a fund is in control, and will need to make a mandatory (general) offer for the outstanding shares of the company held by



minorities. The articles of association of a public company are generally in standard form and personal rights of shareholders cannot be entrenched in the articles of association.

#### 14. What employment terms are generally imposed on management in a buyout?

Long-term agreements are entered into with key personnel of the target company to ensure continuity. Key employment terms include non-compete clauses, confidentiality clauses and provisions for 'gardening leave' to mitigate risks when key personnel resign. Incentive plans tied to company performance may also be introduced to ensure long-term retention of management. However, the use of these incentives is relatively limited in Indonesia and therefore the terms of any incentive may vary considerably and be very much on a case-by-case basis.

#### 15. What equity incentives can be offered to management and how are they typically structured?

Equity incentives are not common in Indonesia because of the regulatory regime (i.e., the need, including for foreign owned companies, to obtain approval for each issue of shares, and, for public companies, to offer securities to all shareholders (unless there is an authorized private placement)). Further, all shares must be issued fully paid up, and equity incentives are taxed. Due to their being very uncommon in the market, the terms of any form of equity incentive will very much be determined on a case-by-case basis.

If the fund decides to take the company public, stock options (with or without lock-ups) issued at the time of listing are a typical incentive available.

#### 16. How are buyouts typically debt financed and secured?

The debt structure generally consists of senior debt and mezzanine debt. Senior debt usually in the form of term loans and revolving credit facilities is usually made available by banks and financial institutions.

Mezzanine debt ranks behind senior debt but ahead of equity capital. Mezzanine debt is usually injected by the fund providing the equity, the seller (if it wishes to maintain a minority interest) or a senior debt provider (in addition to the senior debt). Most funds secure funding from offshore rather than onshore because of the banking regulations and the high domestic interest rates.

Islamic financing is in its infancy in Indonesia and as such is unlikely, for now, to play any significant role in structuring buyouts.

Security is typically obtained through security over a land right (*Hak Tanggungan*), *fiducia* security (being a security interest on movable assets, whether tangible or intangible, and on certain immovable goods) or pledges over the shares being acquired.

#### 17. Are there financial assistance issues to consider when undertaking a buyout?

Subject to the corporate benefit principle, there is no statutory prohibition on a company incorporated in Indonesia providing financial assistance in connection with the acquisition of shares in itself or its parent company (either direct or ultimate). There are, however, minority protection provisions for minority shareholders under the Company Law and Indonesian Securities Law.

## 18. What are the implications under the corporate benefit laws of Indonesia for a company providing financial assistance?

The Company Law requires that the business operations of a limited liability company be carried out in accordance with the company's objectives and purposes as specified in the company's articles of association.

In our view, the capacity of a company to enter into an agreement is not limited to the language of the objectives and purposes clauses but will also include entering into an agreement that facilitates business opportunities or financing opportunities to achieve its business purposes and objectives. The court, based on factual circumstances, will determine the validity of this argument. Although not necessary, specific reference in the corporate approvals (such as in the board of commissioners' approval and the general meeting of shareholders' approval) may strengthen the evidence of corporate benefit.

In relation to the duty of the directors, the Company Law provides that each member of the board of directors must undertake his/her duties in good faith and with full responsibility for the interests and business of the company. While the duty of good faith is not further elaborated on by the Company Law, in practice, one of the principles that generally applies is the principle of 'corporate benefit'. In this regard, a director must act only in what he/she considers to be the best interests of the company.

To minimize any issues in relation to corporate benefit, boards of the company and its shareholders should pass resolutions to 'whitewash' the corporate benefit issues. However, it should be noted that the Company Law contains provisions on lifting the corporate veil under which a company's shareholder could be personally liable for:

- (a) any contract entered into on behalf of the company; and
- (b) for the company's losses in excess of the value of the shares that the shareholder has subscribed for if, among other things, the relevant shareholder:
  - (i) either directly or indirectly, has in bad faith misused the company solely for its own personal interests; or
  - (ii) both directly and indirectly, has used the company's assets unlawfully, causing the company's assets to become insufficient for the settlement of the company's liabilities.

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

The creditors affected by the insolvency are not all in the same position. Preferred or secured creditors have a priority claim on the proceeds of the sale of any assets that have been pledged as security in their favor, whether by way of a pledge, *fiducia* security, mortgage or other privilege. Unsecured creditors, on the other hand, share in the division of the remaining assets and obtain satisfaction of their debts in proportionate percentage. Unsecured creditors will share the money proportionately among themselves. From the date of the declaration of insolvency, unsecured creditors can obtain satisfaction of their claims only by the insolvency procedure and not through individual enforcement proceedings.

The Bankruptcy Law does not confer priority on local creditors over foreign creditors.



## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

### Stamp duty

Stamp duty in Indonesia is not a common law *ad valorem* system and therefore does not need to be considered in determining applicable taxes that may apply (it is nominal at IDR 6,000 and is affixed by way of a duty stamp at the time of signing).

### Income tax

A flat corporate income tax of 25% generally applies in Indonesia. Public companies that satisfy a minimum listing requirement of 40% are entitled to a tax cut of 5% off the standard rate, resulting in an effective rate of 20%.

Indonesia has tax treaties with many other countries to avoid double taxation of income earned in one country by a resident of another country. There is also reduction or exemption of tax on certain types of income (such as interest, dividends, fees and royalties) provided in the tax treaties.

### Withholding tax and capital gains tax

Generally, unlisted shares sold by non-resident taxpayers are subject to a final withholding tax (approximately 5% of the sale price). Non-resident taxpayers may be exempted from tax by the provisions of any applicable tax treaties.

Capital gains on sales of shares in a private company by a resident taxpayer are taxable as ordinary income at 25% for corporate entities and 30% for individuals, while gains on shares listed on the IDX by a resident or non-resident taxpayer are taxed at 0.1% of the transaction value. (An additional tax of 0.5% applies to the share value of founder shares at the time of an initial public offering, subject to certain conditions). Given the differentiation, funds would typically seek an exit once a listing has occurred. Subject to any lock up imposed by regulation, a trade sale could then be undertaken.

## 21. What forms of exit are available?

In solvent situations, the common forms of exit are via initial public offerings or trade sales to strategic investors or to another private equity firm.

Other forms of exit, such as put/call options, can be applied. Despite what may be provided for in a shareholders agreement, however, BKPM requires unanimous shareholder approval for any transfer of shares in a PMA company. This may hamper the execution of a put/call option if there is a shareholder dispute.

## Italy

### 1. What structures do private equity funds typically use to manage their funds?

#### Closed-ended funds

The main vehicle used in Italy for private equity and venture capital funds is the closed-ended fund (*Fondo Comune d'Investimento Mobiliare di Tipo Chiuso*) (**Fondo Chiuso**). Fondi Chiusi are formed and managed by an asset management company (*Società di gestione del Risparmio*) (**SGR**). The SGR, which sponsors the formation of the fund, is responsible for its management and investment decisions.

The SGR operates via its board of directors, management team and advisory/investment committees. It can delegate management functions to another SGR (with which it would be jointly and severally liable in relation to investors in the fund) and also utilize external advisors for the selection of investment targets and their post-acquisition management.

The SGR draws up the fund agreement which sets out a range of issues including:

- (a) the type of investors who can subscribe to fund units;
- (b) the investment policy of the fund;
- (c) the subscription term for the issue of fund units;
- (d) the life of the fund;
- (e) the minimum subscription amount;
- (f) the method and frequency of calculation of the value of the units;
- (g) the cost sharing within the fund (including management fees);
- (h) the SGR and the investors; and
- (i) the liquidation of the fund.

Most funds are reserved to 'professional/qualified' investors, as identified in applicable regulations (**Reserved AIFs**). Units of a Fondo Chiuso are generally illiquid but can be partially redeemed together with divestments of fund assets made during the life of the fund, or subsequent issues of fund units, as specified in the fund agreement, and they can be sold to third parties, depending on the terms of the fund agreement. The proceeds of the fund can be distributed to investors as advance payments during the life of the fund.

The assets of the fund are separated from the assets of the management company and the management company's shareholders. A custodian bank acts as the depository of financial instruments and cash, monitors the issue and redemption of fund units and calculates the net asset value of the fund, in accordance with the fund agreement. Generally, the capital of the fund cannot be invested in assets that are directly or indirectly transferred by a partner, chief officer, general director, or auditor of the SGR, or by companies belonging to the same group of the SGR, nor can assets of the fund be transferred to those persons.

The minimum commitment for professional/qualified investors provided by the fund agreement is often in the range of EUR 250,000 to EUR 500,000 per unit. Fund managers typically invest in the fund alongside other investors. In practice, investors look for manager investment of at least 2% of the fund.



The investment term for most private equity funds is seven to 10 years (or longer for certain asset classes such as infrastructure funds). On average, committed capital is invested over a three to six year period. The carried interest may be subject to the fund exceeding a certain level of return on monies collected from investors.

## SICAFs

The AIFMD (discussed in the answer to question 2 below) introduced a new form of collective undertaking, the SICAF (*società di investimento a capitale fisso*) (**SICAF**), which can be used to set up investment vehicles. The SICAF, to be incorporated in the form of a joint stock company (**S.p.A.**), will generally be subject to the same rules as the Fondi Chiusi and is licensed and is monitored by the Bank of Italy (**BoI**) and CONSOB (the Italian securities and exchange commission being the primary Italian regulator of corporate and financial services). Specific implementing regulations for SICAFs have recently been adopted by BoI and CONSOB.

The initial minimum paid-in corporate capital for a SICAF is EUR 1 million, reduced to EUR 500,000 if the SICAF is reserved to professional/qualified investors. The BoI, in consultation with CONSOB, authorizes the incorporation of the SICAF within 90 days of receipt of the complete application (including organizational structure, planned activities, key managers and related integrity and experience), provided the requirements to ensure sound and prudent management of the SICAF are met.

## 2. Do funds need to be licensed by any regulatory authority to conduct business in Italy?

### Fondi Chiusi

#### *Management company (SGR)*

As mentioned in the answer to question 1, Fondi Chiusi are formed and managed by SGRs, which in turn must be authorized and registered by the BoI, in consultation with CONSOB. SGRs must comply with specific regulations and notice requirements and are subject to continuous supervision by the BoI for matters related to risk limitation and financial stability and CONSOB for matters related to transparency and proper conduct.

SGRs must be established as S.p.A.s with a minimum paid-in corporate capital of EUR 1 million if they intend to carry out financial activities not limited to the asset management of closed-ended funds. A lower threshold of EUR 500,000 is provided for SGRs managing Fondi Chiusi that are majority participated by public investors and devoted to technological and scientific research. The office and key management of SGRs must be based in Italy, and the top executives of the SGR must satisfy specific professional and integrity requirements.

#### *Reserved AIFs*

No approval is required for the fund agreement of Reserved AIFs. Under the new AIFMD regime, Reserved AIFs can be marketed to investors classified as professional/qualified investors under the Markets in Financial Instruments Directive (**MIFID**) and other investors which are yet to be identified by CONSOB.

#### *Investment services*

The promotion and marketing of units of a Fondo Chiuso is considered to be an investment service, and therefore reserved to authorized financial intermediaries (including SGRs and placement agents).

Each public offering or promotion of units of the Fondo Chiuso is considered to be an investment solicitation and is conditional on approval by CONSOB of an offering prospectus. Offerings are exempt from prospectus requirements if:

- (a) they are addressed to fewer than 150 investors;
- (b) they are addressed to MIFID professional investors;
- (c) their aggregate value over a 12 month period does not exceed EUR 5 million; or
- (d) the minimum unitary investment is EUR 100,000.

#### *The marketing and offering in Italy of foreign vehicles for investment in transferable securities*

The marketing and offering in Italy of foreign vehicles for investment in transferable securities, including private equity funds, is subject to different supervisory authority controls depending on whether they are harmonized (under Directive 2009/65/EU, so called UCITS IV) or non-harmonized (under the AIFMD).

Most foreign private equity funds fall into the category of non-harmonized vehicles, whether they take the form of limited partnerships or corporate vehicles, as they will be closed-ended. The offer in Italy of non-harmonized foreign vehicles was previously subject to the prior authorization of the BoI, in consultation with CONSOB. Based on the new regime embodied in the AIFMD implementing regulations, EU AIFs authorized in their home country can now be marketed in Italy under the AIFMD passport regime. EU AIFs may decide to carry out asset management activity in Italy either:

- (a) by setting-up a branch, by giving notice to the home country authority, which will in turn notify the BoI (failure to respond by the BoI within 60 days of receipt of that notice is tantamount to approval); or
- (b) on a cross border basis, on receipt by the BoI of a notice from the relevant home country.

The marketing in Italy of EU AIFs can be effected once the relevant home country authority has notified CONSOB, at which time CONSOB must immediately forward the information contained in the notification letter and all documents annexed to it to the BoI. In relation to the marketing in Italy of non-EU AIFs, pending a decision of the EU Commission under art. 67, paragraph 6, of the AIFMD, the so-called reverse solicitation remains the only option available.

### **3. Are there any approvals required for investments by foreigners in Italy and, if so, what is the process?**

Subject to the powers and approvals discussed below, EU parties wishing to acquire Italian companies or assets are subject to the same rules as those applicable to Italian nationals, while non-EU parties are generally subject to the reciprocity principles embodied or supplemented by international bilateral or multilateral treaties between Italy and the non-EU party's home country.

#### **Industry-specific regulation**

##### *Defense and homeland security*

The Italian Prime Minister may exercise certain powers (**Special Powers**) in relation to transactions involving a 'threat of a serious harm to the essential interests of the national defense and homeland security' (Law Decree No. 21, 15 March 2012). These Special Powers consist of:

- (a) an *ex ante* veto right in relation to shareholders or board resolutions approving mergers, spin-offs, transfers of assets, the transfer of corporate seats outside of Italy, winding up, changes in the articles of association, transfers of ownership or utilization rights concerning tangible or intangible assets;



- (b) *ex post* imposition of specific conditions for the security in the procurement and export of goods, safety of information and data, the transfer of technology, the purchase of participations (shares/quota) in certain entities; and
- (c) *ex post* blocking of the purchases of participations by any entity other than the Italian Government if the purchaser ends up holding a participation that could jeopardize the ‘essential interests of national defense and homeland security’.

Special Powers do not apply to intra-group transactions, if there are ‘no elements pointing to a threat of a serious harm to defense’s and homeland security’s essential interests’.

#### *Energy, transportation and communications*

Subject to certain procedural differences, the Italian Prime Minister may also exercise the Special Powers in relation to strategic assets identified in the energy, transportation and communications sectors (Presidential Decree No. 85, 25 March 2014).

#### Other sector-specific approvals

The prior authorization of regulators is required in relation to transactions in certain sectors, including those listed below.

##### *Insurance*

The acquisition of direct or indirect control, significant influence or certain equity percentages of an Italian insurance or reinsurance company requires pre-approval of IVASS (the Italian insurance regulator). For non-EU entities based in a country where reciprocity is not recognized, the authorization process must also involve the Ministry of Economy and Finance (**MEF**) and the Italian Prime Minister, who are entitled to block the proposed transaction.

##### *Banking*

The BoI must authorize the acquisition of direct or indirect control, significant influence or certain equity percentages of Italian banks. Again, for non-EU entities based in a country where reciprocity is not recognized, the authorization process must also involve the MEF and the Italian Prime Minister, who are entitled to block the proposed transaction.

##### *Aviation*

The right to operate in Italy’s air transportation sector is reserved to companies located in Italy and controlled, directly or indirectly, by an EU member state or EU parties whose main activity consists of air transportation, unless an international convention to which the EU is a party states otherwise.

## 4. Who are the relevant regulators in Italy and how much interaction would one generally expect when undertaking a buyout?

The primary regulatory authorities in Italy in a corporate context are:

- (a) the primary regulator of corporate and financial services (**CONSOB**). CONSOB has authority for matters related to transparency, proper conduct, internal control procedures, offering prospectuses and takeover offers;
- (b) the Italian Stock Exchange (*Borsa Italiana* S.p.A.) (**Borsa Italiana**);
- (c) the Bank of Italy (**BoI**), with authority for matters regarding the limitation of risk and financial stability, as well as approval of acquisitions of shareholdings of Italian banks;
- (d) the Italian competition authority (**AGCM**);

- (e) other authorities with competences in special sectors (such as insurance (**IVASS**) and telecoms/broadcasting (**AGCOM**)); and
- (f) the Italian Government, in relation to, among other things, investments in strategic companies.

The level of expected involvement with CONSOB, Borsa Italiana and other authorities in a buyout situation largely depends on whether the transaction involves a public company and triggers a tender offer. In these cases, interaction is generally higher than in relation to private acquisitions.

Interaction with other authorities largely depends on the nature and size of the transaction (e.g., industry sector and relevant competition/antitrust issues) and the parties concerned.

## 5. How are buyouts typically undertaken in the private and the public markets?

### Private companies

Buyouts in Italy typically involve the acquisition of all of, or a majority interest in, the target company. Buyouts of privately owned companies are commonly structured as a share purchase using special purpose acquisition vehicles. (Asset purchases are less common.)

Auctions have become reasonably common for buyouts of private companies. Auction procedures are not regulated but generally follow a ‘standard’ process starting with an information memorandum in relation to the target circulated by financial advisors to selected potential investors (subject to execution of a non-disclosure agreement). After non-binding offers are submitted, a restricted number of potential investors is allowed to conduct due diligence and management interviews (and vendor due diligence reports are often made available). The potential investors are generally provided with a draft share purchase agreement prepared by the seller’s counsel. Bids including a mark-up of the purchase agreement are then submitted, followed by final negotiations with the selected buyer.

### Public companies/tender offers

Buyouts of public companies must comply with the Italian financial markets regulations which are designed to promote disclosure, equal treatment for all shareholders and market stability. The Italian mandatory tender offer rules are summarized below.

#### *OPA Totalitaria*

If one or more investors acting in concert come to own more than 30% of securities entitled to vote at the listed target shareholders’ meetings convened for the appointment/revocation of directors (**Voting Securities**) or, regardless of the percentage of Voting Securities, more than 30% of the voting rights exercisable at the listed target’s shareholders’ meetings convened for the appointment/revocation of directors (**Voting Rights**), they must make an offer to buy all the Voting Securities belonging to any class traded on a regulated stock exchange (**OPA Totalitaria**)<sup>13</sup>. The offer must be promoted within 20 days of hitting the 30% threshold, at a price not lower than the highest price paid by the investor(s) (offeror(s)) for Voting Securities of the same class in the previous 12 months or, if no purchases were made by the offeror(s), the weighted average market price of the Voting Securities in the previous 12 months or the shorter period for which market prices were available.<sup>14</sup>

---

<sup>13</sup> Assuming more than one class of such securities has been issued by target and admitted to a regulated stock exchange.

<sup>14</sup> The weighted average market price applies also in the event that the 30% threshold is hit as a result of the kick-in of the ‘*increased voting rights*’ referenced in this answer, provided the offeror(s) did not purchase any Voting Security at a higher price in the previous twelve months.



For targets that do not qualify as a Small Medium Enterprise/SME (**Non-SME Target**), the obligation to launch an OPA Totalitaria also applies when one or more investors acting in concert come to own, as a consequence of purchases, more than 25% of the Voting Securities or Voting Rights if at that time no other shareholder of the listed target already holds more than 25% of the Voting Securities or Voting Rights.

#### *OPA Preventiva Parziale*

The obligation to make a public offer does not arise when the 30% threshold (or 25% for a Non-SME Target) is exceeded by way of a voluntary tender offer addressed to at least 60% of Voting Securities, if the offeror has not purchased more than 1% of Voting Securities in the 12 months prior to, or during, the offer and that offer is accepted by shareholders owning the majority of Voting Securities, net of the participation owned by the offeror and/or by the majority shareholder, if that participation exceeds, severally, 10% of the Voting Securities.

After the voluntary tender offer, investors must promote an additional offer to buy all the outstanding Voting Securities if, during the 12 months following the close of the first offer:

- (a) the investors purchase more than 1% of Voting Securities; or
- (b) the listed target is involved in a merger or spin-off.

#### *OPA Totalitaria a Cascata*

If one or more investors acting in concert come to own, either indirectly or by computing together their direct and indirect participations in the listed target, more than 30% of the listed target's Voting Securities/Voting Rights or 25% for a listed non-SME Target (if at that time no other shareholder of the listed target already holds more than 25% of the Voting Securities/Voting Rights), they must launch an OPA Totalitaria in relation to all the outstanding Voting Securities of the same listed target (**OPA Totalitaria a Cascata**).

#### *OPA Incrementale*

If one or more investors acting in concert, already holding more than 30% (but less than 50%) of the listed target's Voting Securities/Voting Rights, acquire, directly and/or indirectly (i.e., by computing direct and indirect participations), more than 5% of the outstanding Voting Securities or Voting Rights in less than 12 months, they must make an offer to buy all the Voting Securities of the listed target (**OPA Incrementale**).

#### *OPA Residuale*

When a person or persons acting in concert come to own more than 90% of the listed target's Voting Securities, they must acquire all the outstanding Voting Securities traded on a regulated stock exchange which may be offered to them by outstanding security-holders, at the price paid for the previous offer or, if there was no offer, at the price determined by CONSOB, unless within 90 days they restore a free float sufficient to ensure regular trading. If more than one class of Voting Securities has been issued, the purchase obligation applies only to those classes of Voting Securities for which the 90% threshold is exceeded.

#### *Diritto di sell-out and Diritto di squeeze-out*

When the shareholding exceeds 95% of the listed target's Voting Securities as a result of a tender offer to buy all Voting Securities:

- (a) the investors must acquire all the outstanding Voting Securities that may be offered to them by outstanding security-holders, at the price paid in the offer. If more than one class of Voting Securities has been issued, the purchase obligation of the investor applies only to those classes of securities for which the 95% threshold is exceeded (sell-out right); and, conversely

- (b) the investor is entitled to acquire the remaining Voting Securities within three months of the close of the offer, if the investor reserved that right in the offering document (squeeze-out right).

#### *Tender offers for Small Medium Enterprises*

Mandatory tender offers in relation to an SME listed target are subject to the same rules applicable to large/standard public companies, except for the following (Law Decree No. 91, June 24, 2014 as converted by Law dated August 7, 2014 (**2014 Competitiveness Decree**)):

- (a) the articles of association of an SME listed target may vary the standard 30% threshold of Voting Rights and Voting Securities triggering the duty to launch an OPA Totalitaria (including the case of the OPA Totalitaria a Cascata and OPA Incrementale) to a different percentage ranging from 25% to 40%, as determined by its shareholders' meeting and as set out in its articles of association. Non-attending, dissenting and abstaining shareholders have the right to withdraw from the SME listed target; and
- (b) the articles of association of an SME listed target may provide that, until approval of the financial statements related to the fifth fiscal year following the year of the listing, the rules of the OPA Incrementale do not apply.

#### *Other*

To initiate a buyout of a public company, an investor must communicate its intention in advance to CONSOB and prepare an offering document for publication.

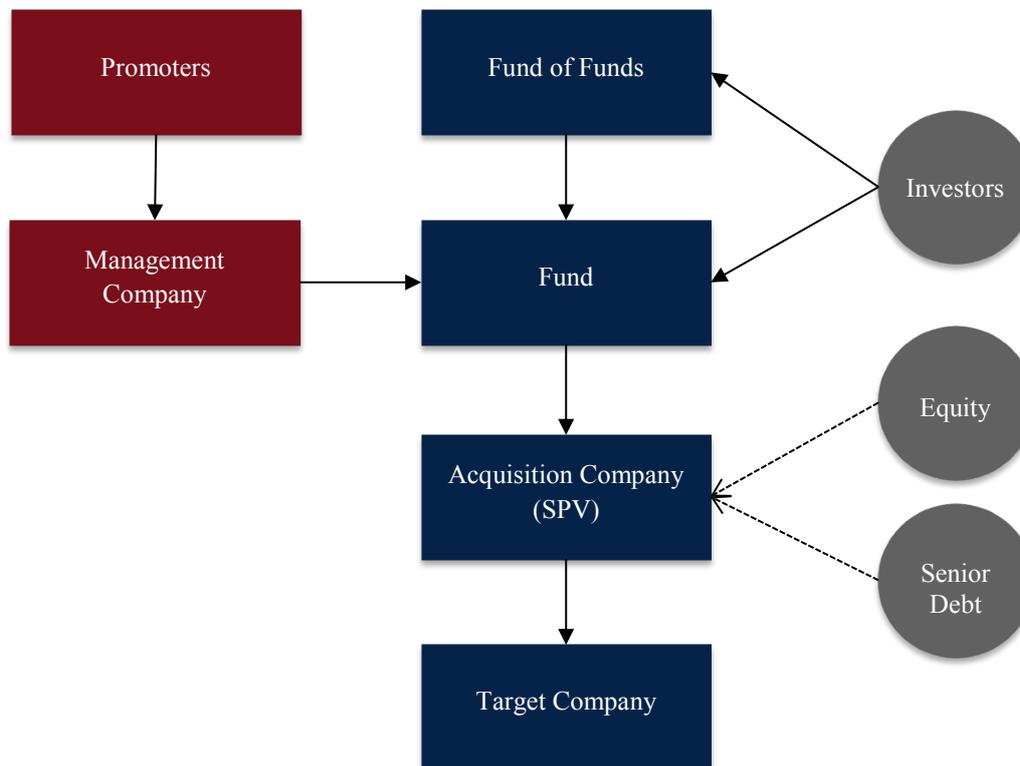
In the event of a foreign tender offer, the 'passivity' and 'breakthrough' rules that regulate the behavior of the listed target and its shareholders during the offer period to prevent them from hampering the offer, only apply to the benefit of the offeror if reciprocity exists in the latter's home country.



## 6. What is the typical corporate structure used when doing a buyout?

Investors may opt to invest in private equity funds or funds of funds (or directly into targets).

The typical basic structure for a private equity investment is set out in the chart below.



This structure allows for senior debt finance to be provided to the special purpose vehicle incorporated as the acquisition company (**Acquisition Company**) (with junior debt also kicking in for larger transactions). The Acquisition Company generally also receives equity injections from the private equity funds involved in the transaction.

The Acquisition Company is a newly formed special purpose vehicle which is typically incorporated in one of two forms of corporation that give limited liability to the shareholders as follows:

- (a) S.p.A.- a joint stock corporation (*società per azioni*) with a minimum capital of EUR 50,000, the S.p.A. is generally utilized for large size businesses and public companies (and related LBOs). An S.p.A. can be either a private or public company; and
- (b) S.r.l.- a company (*società a responsabilità limitata*) (**S.r.l.**) with a minimum capital of EUR 1 divided into quotas, the S.r.l. is normally used for captive, closely held or smaller scale businesses where there is only one stakeholder, or where the stakeholders are interested in a more streamlined structure. S.r.l.s are private companies.

## 7. What transaction documentation is usually prepared when undertaking a buyout?

The following documentation is typically prepared when undertaking a buyout of a privately-owned target company:

- (a) the investment/share purchase/asset purchase agreement;
- (b) management agreements;

- (c) the articles of association; and
- (d) financing agreements.

Other ancillary transactional documents may be required, depending on the size and nature of the deal.

The content of these documents is influenced by many factors, for example, tax mitigation, local legal requirements and structural considerations. These documents also need to take into account commercial issues negotiated by the buyer including:

- (a) ownership and control of the investee business post-investment;
- (b) share transfers (mandatory, permitted and prohibited) and pre-emptive rights;
- (c) incentives for the management of the investee business and obligations imposed on them;
- (d) the division of managerial responsibilities following the investment;
- (e) warranties, representations and indemnities;
- (f) milestones and any future obligations to provide further funding;
- (g) board and shareholder consents needed before specified actions are taken;
- (h) agreements with lenders to the investee business;
- (i) the quality, quantity and frequency of information that is to be provided; and
- (j) exit provisions such as tag-along or drag-along rights and/or compulsory sale provisions to resolve any deadlock regarding disposal.

The main banking document is generally the senior facilities agreement but junior debt (mezzanine, second lien, payment-in-kind (PIK)) documentation also comes into play for larger transactions.

## **8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?**

### **Private companies**

In a private context, buyer protections usually take the form of negotiated warranty & indemnity coverage from sellers (in a share sale transaction) or the company (in an asset/business sale transaction). In management buyout transactions where private equity funds co-invest, specific warranties may also be sought from management shareholders. The terms of that coverage vary from transaction to transaction, but are normally subject to thresholds and caps, time limits and adjustments for items otherwise disclosed or accounted for. Buyers may also seek warranty & indemnity insurance, or a bank guarantee (more common than Warranty & Indemnity insurance coverage), or the ability to place a portion of the sale proceeds in escrow for a certain period of time.

### **Public companies**

In a public context, the level of buyer protection which can be obtained is less than in a private context. The primary form of protection usually takes the form of conditions precedent to the acquisition. Warranty protection from target shareholders is very limited and generally only extends to confirmation in relation to unencumbered title and due authority to sell.



## 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

Potential conflicts in a management buyout are not specifically regulated, but the Italian Civil Code (**Civil Code**) imposes certain general statutory obligations on directors and officers of a corporation not to misuse their positions to advantage themselves or disclose any information that they may receive from an investee business, including the following:

- (a) unless expressly authorized by the shareholders' meeting, directors must not engage in competitive activities;
- (b) executive directors must abstain from engaging in activities that result in a conflict of interest and defer to the board who makes a choice about whether the relevant director can engage in these activities; and
- (c) when voting at board meetings, directors must disclose any actual or potential conflict of interest situation, including potential management buyouts.

Additional general guidance in relation to conflicts of interest can be found in the code of conduct adopted by public companies.

## 10. How are the equity arrangements typically regulated in a buyout?

The equity arrangements in a typical buyout are regulated primarily by a shareholders agreement. Its purpose is to establish the ownership structure and the corporate governance of a company.

Shareholders agreements can be entered into either for a definite (and renewable) term not exceeding five years for private S.p.As (that term can be extended for S.r.l.s.), and can be reduced to three years for public S.p.As. Alternatively, for both private and public companies, an indefinite period can be agreed on but in that case the parties can withdraw at any time by six-month prior written notice. A definite term is the preferred route in LBO transactions.

Equity arrangements are also tailored in relation to the rights attached to the relevant classes of security, as reflected in the articles of association of the target company.

Shareholders agreements for public S.p.As or their controlling companies must be:

- (a) notified to CONSOB;
- (b) communicated to the target company;
- (c) published in abstract on the public company's website; and
- (d) filed with the local Register of Companies within five days of execution.

Failure to do so results in the shareholders agreement being null and void and the loss of voting rights attached to the shares referred to in the relevant shareholders agreement (although they are counted for the purposes of establishing quorum at a shareholders' meeting).

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

Classes of equity security which may be issued to private equity funds vary according to the nature of the target company.

## S.r.l.s

For S.r.l.s (generally used for small scale business entities), while there are no ‘classes’ of quotas, the articles of association may give certain quota-holders a participation not proportional to the capital contribution made and/or specific rights related to the management of the company or the distribution of profits.

## S.p.As

S.p.A.s enjoy a great deal of flexibility in relation to the issue of various classes of shares, other than ordinary shares, including:

- (a) preference shares with priority in the distribution of profits and on liquidation of the company;
- (b) limited voting shares;
- (c) ‘savings’ shares with no voting rights (for public companies);
- (d) shares giving rights correlated to specific economic results;
- (e) redeemable shares;
- (f) *ad hoc* financial instruments (other than shares) bearing certain administrative and economic rights; and
- (g) convertible bonds.

## Multiple Voting Rights Shares

The 2014 Competitiveness Decree has introduced the possibility of private and (in limited cases) public S.p.A.s issuing shares with multiple voting rights of up to three votes per share (**Multiple Voting Rights Shares**). The articles of association allowing the issue of Multiple Voting Rights Shares must also determine whether multiple voting rights are exercisable only in relation to certain shareholders’ matters or without restrictions.

## Increased Voting Rights Shares

For public companies which did not issue Multiple Voting Rights Shares, the 2014 Competitiveness Decree has also introduced the possibility of giving ‘increased voting rights’ (up to two votes per share), to those shares kept for a minimum holding period of at least 24 consecutive months (possibly taking into account the holding period prior to listing), if allowed in the articles of association of the company at the time of the listing (**Increased Voting Rights Shares**). Increased voting rights cease if there is a direct or indirect change of control over the owner of the Increased Voting Rights Shares, if at that time that shareholder holds voting rights in excess of certain thresholds (currently, 2% in the case of Non-SME Targets and 5% in the case of listed SME targets).

Increased voting rights attached to Increased Voting Rights Shares extend to newly issued shares in the context of free capital increases (out of available reserves), as well as other types of capital increases if allowed in the articles of association of the company. In the case of mergers/demergers not triggering a change of control, increased voting rights may be transferred to newly issued shares as per the exchange ratio and as set out in the merger/demerger agreement.

## Avoiding mandatory tender offer requirements

If, as a consequence of the kick-in of Increased Voting Rights Shares, shareholders come to own a percentage of Voting Rights in excess of the mandatory tender offer thresholds, they must launch an applicable mandatory tender offer (i.e., OPA Totalitaria, OPA Totalitaria a Cascata or OPA



Incrementale). To avoid the mandatory tender offer, the articles of association of a listed target may allow the shareholders to irrevocably waive, prior to the elapse of the minimum holding period, in whole or in part, the increase of the voting rights attributed to their shares, so as to maintain the original percentage (or limit the increase) of Voting Rights.

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

Rules governing the board constituency, directors' voting rights and removal and appointment of directors are set out in the Civil Code. These provisions are commonly enshrined in the shareholders agreement to secure the specific appointment and removal rights of certain investors in relation to a certain number of directors in the target company.

S.r.l.s and S.p.A.s are generally governed by the so-called traditional system, characterized by a sole director or board of directors as managing bodies, a panel of statutory auditors or a sole auditor as the legal compliance and auditing body, and an external auditor for the audit of the company's accounts if the panel of statutory auditors is only vested with legal compliance tasks, or if the company is public. S.p.A.s however can opt for either the one-tier system or a dual system. The dual system involves the establishment of two separate bodies (i.e., a supervisory board and a managing board appointed by the supervisory board).

Italian corporate law does not contemplate differential director voting rights, and directors' votes may not be cast by proxy. Alternative directors are not permitted. Ballot or circular resolutions are allowed only for S.r.l. companies.

Directors of S.p.A.s are appointed for mandates of no longer than three years, whereas directors of S.r.l.s may hold their office until revocation of their appointment or resignation (unless provided otherwise in the articles of association). Directors of both S.p.A.s and S.r.l.s may be dismissed by the ordinary shareholders' meeting but if the dismissal is without cause, the company could be liable for damages *vis à vis* the dismissed director.

## 13. What measures are commonly used to give a private equity fund some level of control over key operating and financial decisions made by a portfolio company?

Control over key operating and financial decisions made by a portfolio company would normally be achieved by including provisions in the shareholders agreement in relation to:

- (a) the appointment of members of the board of directors and key executives over the investee business;
- (b) veto rights on strategic decisions (e.g., the business plan) at the board and shareholders' level;
- (c) rights, mechanics and procedures to receive financial and operating information on a regular basis; and
- (d) drag-along rights and other rights to cause an IPO or trade sale (typically reserved for the sponsors).

The level of control/constraints on the target company's operating management depends on a number of factors, including the size of the fund's investment, the SGR management team's ability to add value to the investee business, and the level of influence that the SGR management team considers to be appropriate.

## 14. What employment terms are generally imposed on management in a buyout?

Management services agreements entered into at the time of the investment are typically used to set out the interaction among the buyer, the board and the management of the investee company.

Managers would usually be hired as ‘continuous and coordinated collaborators’ or high level employees. Managers would normally be prevented from leaving the company for a prescribed period of time and subject to, among other things, non-compete, non-solicitation and non-disparagement obligations, confidentiality obligations as well as good and bad leaver provisions. Public companies operate under statutorily regulated confidentiality requirements in relation to price sensitive information.

Managers who are also employees must perform their obligations according to a general duty of loyalty to the employer, a breach of which may result in the employee’s dismissal.

## 15. What equity incentives can be offered to management and how are they typically structured?

The most common management equity incentives are listed below.

### Equity interests

In buyout transactions involving private equity funds, management would usually purchase a shareholding in the target company ranging from 1 to 5%.

### Performance ratchet/equity ratchets

Management is entitled to receive a higher portion of equity on exit of the investment if it achieves a minimum overall internal rate of return (and possibly money multiple) on that investment.

### Stock options

Company managers usually receive stock options in respect of the shares of the investee company. The strike price of the options would normally be equal to the price of the shares at the date of the purchase of the participation by the fund.

Stock options for company managers and employees are generally considered to be employment taxable income (progressive income tax rate), the taxable base being the difference between:

- (a) the market value of the shares on the day of their purchase; and
- (b) the price paid by the manager/employee on the exercise of the option.

### ‘Good leaver’ and ‘bad leaver’ provisions

‘Good leaver’ and ‘bad leaver’ provisions are very common and usually contemplate the right (or obligation) of the fund/buyer to acquire the equity at a pre-determined price in a leaver situation.

## 16. How are buyouts typically debt financed and secured?

### Lending

The most common debt sources in buyout transactions are senior and secured loans, and, for larger transactions, mezzanine, second lien and PIK financing. A significant portion of the cost of an acquisition, generally depending on EBITDA or other multiples related to the target, would be sourced from lenders.



Monies would normally be lent to a special purpose acquisition vehicle wholly-owned by the fund (either directly or via another holding company) and part of the monies could then be injected into the investee company for its operational needs (especially for start-up companies) by way of equity or shareholder loans.

In LBO transactions, Italian rules in relation to financial assistance (discussed below in the answer to question 17) and transfer pricing must also be considered.

## Security

In relation to the form of protection to debt providers, in addition to traditional collateral methods (pledges, mortgages, special liens), the Consolidated Banking Act provides for a special form of security (*Privilegio Speciale*) for the benefit of all banks issuing medium and long term financing (in excess of 18 months). In essence, the lending bank and the borrower may agree that the financing is secured by a special lien on all movables (whether tangible or intangible, such as patents) except those recorded in public registers. The borrower may therefore secure in favor of the bank all unregistered assets relating to the business, including those assets that will eventually be replaced or transformed into different goods.

## Subordination

Subordination is also a contractual safeguard to creditors. Creditors most likely to agree to subordinate debt loans would include:

- (a) high yield debt holders who agree to subordinate in exchange for a higher risk return (e.g., mezzanine lenders);
- (b) an owner providing financing to the buyer to allow the buyer to obtain additional financing from another lender; and
- (c) existing creditors agreeing to subordinate their loans to attract additional financing in a turnaround or work-out situation.

However, while solvent companies can contract to prioritize debt payment, an insolvent company remains subject to bankruptcy laws that do not recognize contractual subordination. In that case, creditors would be ranked according to Italian bankruptcy legislation.

## 17. Are there financial assistance issues to consider when undertaking a buyout?

### Joint stock companies (S.p.A.)

Prior to September 30, 2008, the Civil Code prohibited any company incorporated in Italy in the form of an S.p.A. from granting loans and/or guarantees/security interests for the purpose of supporting the purchase of, or the subscription for, its own shares. However, the current position is that the granting of financial assistance by an Italian company incorporated in the form of an S.p.A. is no longer prohibited if the following ‘whitewash’ procedure (set out in Article 2358 of the Civil Code) is complied with:

- (a) the granting of financial assistance has been authorized by an extraordinary shareholders’ meeting of the company providing the financial assistance;
- (b) the directors of the company providing the financial assistance have prepared a written report outlining the proposed transaction, from a legal and economic perspective (**Transaction Report**);
- (c) if the financial assistance is aimed at permitting the company providing the financial assistance to acquire owned shares, then:

- (i) the extraordinary shareholders' meeting referred to in (a) above must also authorize the terms for the disposal of those shares; and
- (ii) the purchase price of the shares must be calculated on the basis of certain criteria (which vary depending on whether or not the shares are listed on a regulated market);
- (d) if the company providing the financial assistance is required to provide financial assistance for the purpose of enabling its directors, the directors of its parent company or the parent company itself to purchase its shares, the Transaction Report must also attest that the proposed transaction 'pursues' the best interest of the company providing the financial assistance; and
- (e) the aggregate amount of the loans and the guarantees/security interests granted by the company providing the financial assistance cannot exceed the aggregate amount of its profits and reserves available for distribution as shown in the most recently approved balance sheet of the company providing the financial assistance (net of any amount applied by the company for the acquisition of its own shares in accordance with Article 2357). In this respect, the financial assistance provider must record in its balance sheet a reserve, not available for distribution, equal to the amount of the aggregate financial assistance granted.

Neither a shareholders' authorization nor any other requirements (except for the need to record details in its balance sheet as described above) will apply to transactions aimed at allowing the employees of a company, or of any other company controlling, or controlled by, that company to acquire its own shares.

#### Limited liability companies (S.r.l.)

Article 2474 of the Civil Code applies to companies incorporated in the form of an S.r.l and provides that an S.r.l. is prohibited from providing financial assistance in any form. The 'whitewash' procedure does not apply to these companies.

### 18. What are the implications under the corporate benefit laws of Italy for a company providing financial assistance?

If a company breaches the financial assistance prohibition, any loan, guarantee or security provided as financial assistance is void, null and unenforceable. Also, the breach may result in personal liability of the directors of the company granting or issuing the loans, guarantees or security for breach of their duties arising out of law (Article 2392 of the Civil Code).

### 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

In any insolvency situation secured creditors rank ahead of unsecured creditors, which rank ahead of shareholders (both in respect of equity and shareholder loans).

Ranking of creditors in an insolvency situation is in the following order of priority:

- (a) expenses related to the insolvency procedure;
- (b) creditors secured with collateral (pledge, mortgages, liens) up to the amount of sale proceeds (the unsatisfied portion of the debt ranks *pari passu* with unsecured creditors);
- (c) privileged creditors such as employees, social security and the tax administration;
- (d) unsecured creditors;
- (e) shareholder loans; and



(f) shareholders' equity.

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

### Transfer taxes

The transfer of title to shares in S.p.A.s by way of endorsement of the share certificates is subject to the so-called 'Tobin tax'. The Tobin tax is levied on any transfer of title to shares in an S.p.A. as well as in joint stock companies with registered offices in Italy, even if this type of transaction is executed between individuals/entities that are not resident in Italy.

Purchasers of shares pay the tax on the sum paid for the shares. For shares of listed companies, the Tobin tax applies at a tax rate of 0.1% (with an exemption for companies whose average market capitalization on November of the year prior to the year when the transaction was entered into is lower than EUR 500 million); for non-listed companies, the rate is 0.2%.

The final quota transfer agreement (in S.r.l. companies) is subject to a fixed registration tax equal to EUR 200 unless a third party (e.g., the parent company of a party) is acting as guarantor to the agreement in which case guarantees are subject to tax at 0.5%, applicable to the total guaranteed amount. The seller and the purchaser are jointly liable for the payment of the registration tax.

### Income and withholding tax

Funds are not subject to income tax, and interest, dividends and capital gain are generally received gross of withholding taxes. Earnings of funds are usually taxed in the hands of the investors, as described below.

Investor income (distribution of earnings by the fund or the positive difference between the subscription and redemption value of units) and capital gains for Italian-resident corporates are subject to corporate income tax at a current rate of 27.5%.

Non-Italian resident corporates and institutional investors whose country allows satisfactory exchange of information with Italian tax authorities and certain international bodies are exempt from withholding taxes. Otherwise, a 26% withholding tax applies.

### Dividends

As shown in the answer to question 6, foreign private equity funds typically invest through an Italian resident special purpose acquisition vehicle (**SPV**). This indirect investment allows an efficient optimization of the tax leverage via the domestic consolidated taxation system and further allows financial institutions to obtain adequate guarantees (shares pledge) from the SPV. This structure is efficient as the SPV can benefit from the participation exemption regime in respect of both dividends distributed by the target and any capital gains realized from the disposal, either total or partial, of the participation in the target company, as described below.

Dividends distributed by an Italian resident company (target) to another Italian resident company (the SPV) are exempt from the 27.5% standard corporate income tax in relation to 95% of the dividend. This translates into an effective tax rate levied on the amount of the distributed dividends equal to 1.375%. In turn, dividends distributed by the SPV to the fund would not be subject to withholding tax.

### Capital gains tax

Capital gains realized by an Italian resident SPV from the sale of its participation in another Italian resident company (target) are subject to the same participation exemption regime applicable to dividends (resulting in a 1.375% tax rate), provided the following requirements are met:

- (a) designation of the shareholding as a long-term investment in accordance with applicable Italian Generally Accepted Accounting Principles (Italian GAAP) in the first annual accounts approved after its acquisition or as financial instruments other than those held for trading, if the SPV adopts IAS/IFRS;
- (b) uninterrupted ownership of the shareholding for a period of at least 12 months; and
- (c) the target is engaged in the conduct of a ‘real business activity’ for at least three fiscal years prior to the sale. Companies whose main activity consists of the ownership and management of real estate never qualify as being engaged in a ‘real business activity’.

The requirement in (c) above need not be satisfied if the target is listed on a regulated market.

### Deductibility of interest

Interest on financing of a buyout transaction is deductible up to a threshold equal to the aggregate of active interest and similar items of income realized by the borrowing company. The amount of interest exceeding that amount (**Net Interest**) can be deducted up to 30% of the company’s EBITDA. Net Interest in excess of 30% EBITDA may be carried forward and deducted in subsequent fiscal years, without a time limit if, and to the extent that, the Net Interest in the relevant fiscal year is lower than 30% of the company’s EBITDA in the relevant fiscal year.

Holding companies such as the SPV would normally have EBITDA equal to zero or negative (as dividends received from the target company should not be computed in the calculation of the EBITDA of the SPV). However, if the SPV and the target company elect to adhere to the domestic consolidated taxation system, interest paid by the SPV would be deductible up to 30% of EBITDA of the target company.

In relation to companies owning real estate as fixed or current assets, interest included among real estate costs is not subject to the above limitations on interest deductibility. Interest related to mortgage loans is also deductible without limitations.

### Dummy companies regime

Another relevant aspect in a buyout transaction implemented via an SPV is the Italian ‘dummy’ companies regime. Under this regime, Italian resident companies regarded as ‘dummy’ entities must report a minimum taxable income calculated by applying certain coefficients to the values of different types of assets owned by the company (the coefficient for participations is 1.5%). Under certain conditions, relief from the dummy companies regime applies (e.g., when the SPV controls a target company listed on a regulated market).

### Upstream or downstream mergers

Acquisition of the shareholding in a target by an SPV is often followed by an upstream or a downstream merger. (From a tax perspective a merger is not a taxable event, either in the hands of the merged companies or of the relevant shareholders.) If the original book value of the shareholding held by the SPV exceeds the net equity of the target, the book value of the tangible and intangible assets of the target is increased. In that case, the company resulting from the merger may elect to align, totally or partially, the tax basis to the stepped-up book value of these assets, by paying a substitute tax (ranging from 12% to 16%). The annual depreciation of the stepped-up tax basis of the assets is then deducted from the company’s taxable income for corporate income tax and local trade tax (IRAP) purposes (whose aggregate tax rate is approximately 31%).



## 21. What forms of exit are available?

In a solvent situation the most common exit strategies include IPOs and trade sales, either of the company or the underlying business, with the consequent advantages and disadvantages, well known in the private equity industry.

In some circumstances private equity funds may seek to realize returns during the life of the investment by arranging for a leveraged recapitalization of the target company and subsequent capital distribution or buy-back.

## Japan

### 1. What structures do private equity funds typically use to manage their funds?

There are several forms of partnership agreement available under Japanese law. The four most commonly used as a structure for private equity funds in Japan are:

- (a) a voluntary partnership (*nin'i kumiai*) (**NK**);
- (b) an investment limited partnership (*toshijigyoyugensekinin kumiai*) (**Investment LPS**);
- (c) a limited partnership (*yugensekinin kumiai*) (**LPS**); and
- (d) silent partnership (*tokumei kumiai*) (**TK**).

The key differences between these structures from an investor's perspective are:

- (a) an NK consists of only unlimited liability partners with each partner having unlimited liability *vis à vis* creditors of the partnership;
- (b) an Investment LPS consists of limited liability partners and unlimited liability partners (i.e., general partners) with limited liability partners being liable only to the extent of their respective investments;
- (c) an LPS consists of only limited liability partners, which are liable only to the extent of their respective investments. All limited liability partners are required to be involved in the management of an LPS; and
- (d) a TK is a bilateral agreement between a TK operator (*eigyosha*) and a TK investor (*tokumei kumiai in*) under which the TK investor invests in the TK operator's business and receives a share of the profit (or loss) generated from the business. The TK investor is merely a creditor of the TK operator and, unlike the other forms of partnership above, has no joint ownership rights over the TK operator's assets. The TK investor is liable only to the extent of its investments.

The Investment LPS is most commonly used for investment funds managed by major Japanese private equity firms. The NK is also popular due to the greater flexibility it offers compared to the Investment LPS, although, as mentioned above, each partner has unlimited liability *vis à vis* creditors.

Funds adopting any of the above-mentioned structures can invest in listed or unlisted companies.

Many domestic funds sometimes also use limited partnership structures based in foreign jurisdictions (such as the Cayman Islands) in conjunction with domestic structures.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in Japan?

Generally, the fund manager must be registered with the relevant Japanese authority as an investment manager if the fund invests primarily in securities and/or derivatives as defined in the Financial Instruments and Exchange Act (**FIEA**). This requirement applies to fund managers of foreign investment funds, subject to certain limited exceptions, if the fund has investors resident in Japan.



The registration requirement applies whether the fund is in the form of an NK, an LPS, an Investment LPS or a TK. However, certain exemptions are available where:

- (a) the investors of the fund consist of one or more ‘qualified institutional investors’ and there are no more than 49 ordinary investors; or
- (b) the fund enters into a discretionary investment management agreement with a registered investment manager so that the registered investment manager manages the partnership’s assets.

### 3. Are there any approvals required for investments by foreigners in Japan and, if so, what is the process?

#### Foreign investment

Foreign investment in Japanese companies and businesses is regulated under the Foreign Exchange and Foreign Trade Act (**FEFTA**). The Ministry of Finance (**MoF**) and the Ministry of Economy, Trade and Industry (**METI**) enforce FEFTA.

Generally, Japan does not have strict restrictions on foreign direct investment, although certain reporting or approval requirements may apply depending on:

- (a) the jurisdiction in which the investor is located (i.e., whether it is a jurisdiction currently approved by the Minister of Finance);
- (b) the industry in which the target company or business operates (i.e., whether or not the industry in question is a regulated industry); or
- (c) in the case of asset acquisitions, the nature of the particular asset involved (for example, acquisitions of real property located within Japan generally must be reported, but personal property (other than gold bullion), is generally exempt from these requirements).

#### *General case filing obligation*

In general, a foreign investor (usually foreign corporations) must file an after-the-fact report with the MoF and other relevant Ministers through the Bank of Japan (**BOJ**) by the 15th day of the month following the month in which the investor acquires shares in a Japanese company. This filing is generally regarded as a mere formality and does not require extensive disclosure of information.

However, no after-the-fact report is required if, as a result of the acquisition, the foreign investor and any related companies do not in the aggregate hold 10% or more of the issued shares in a Japanese company. Note also that if a foreign investor purchases 10% or more of the issued shares in a Japanese listed company from a foreign seller, an after-the-fact report is also required.

This is a requirement irrespective of whether the target is a non-listed company or a listed company.

## Advance notice requirements

Foreign investors purchasing any number of shares in a company<sup>15</sup> in Japan must file at any time during the six months prior to the acquisition, advance notice, and within 30 days after the acquisition, an execution report with the MoF and any other relevant ministers through the BoJ if either:

- (a) the investor is located in a jurisdiction that is not included in the MoF list of designated jurisdictions (e.g., Libya, Iraq and North Korea);
- (b) the target company is engaged in business in a regulated or sensitive industry or sector; or
- (c) the investor is Iranian and acquires shares in a company which operates a business in which Iranian investment is prohibited.

Regulated or sensitive industries include telecommunications, agriculture, fisheries, petroleum, leather goods, aerospace, nuclear power, gunpowder and armaments.

Transactions requiring advance notice are subject to review and approval.

### *Offshore share acquisitions*

Foreign investors who acquire shares in a non-listed company from another foreign investor need not file a prior notification or after-the-fact report regarding the acquisition. A foreign investor that acquires shares in a listed company from another foreign investor is also not required to file a prior notification or after-the-fact report regarding the acquisition if, as a result of the acquisition, it and any related companies hold less than 10% of the listed company's issued shares. However, if the foreign investor disposing of the shares previously filed a prior notification under the FEFTA, that foreign investor will be required to file an after-the-fact report with the MoF.

## Exchange controls

One of the stated aims of the FEFTA is to liberalize foreign exchange and foreign trade – i.e., subject foreign investment to as little regulation and compliance duties as possible. Capital flows relevant to mergers and acquisitions in Japan are therefore largely free of government controls.

However, cash remittances of more than JPY 30 million into or out of Japan must be reported to the MoF. This reporting obligation is directed at and applicable to residents only. In practice, however, the Japanese bank involved in such remittance usually prepares and files such report on behalf of its customer as a service for its customer. The repatriation of profits and dividends by branches and subsidiary forms is unrestricted in Japan. Bond issues, whether overseas by Japanese residents or by foreign residents in Japan, do not require government approval. However, issues involving sums of JPY 100 million or more may be subject to an after-the-fact reporting requirement.

## 4. Who are the relevant regulators in Japan and how much interaction would one generally expect when undertaking a buyout?

The primary regulatory authorities in relation to a buyout in Japan are:

- (a) the Ministry of Finance (**MoF**) - oversees takeovers, foreign investment and other investment activities (through local Finance Bureaus and the BOJ) regulated under the Foreign Exchange and Foreign Trade Law, the Securities and Exchange Law and several other laws;

---

<sup>15</sup> For the exceptional case filing obligation, the 10% threshold of aggregate holdings does not apply, except in case of acquisitions of the shares of a listed company (in which case the exceptional case filing obligation will be required only if, as a result of the acquisition, the investor and any related companies in the aggregate hold 10% or more of the issued shares in the listed company).



- (b) the Financial Services Agency - regulates licensing of participants in the financial services industry, and acts on information gathered via suspicious transaction reporting, etc.;
- (c) the Stock Exchanges (including the Tokyo Stock Exchange, Nagoya Stock Exchange and JASDAQ) - set and administer rules and standards for the companies listed on those exchanges;
- (d) the Fair Trade Commission - may review a direct or indirect acquisition of a Japanese company or business under the Anti-Monopoly Law and has the power to order the parties to a transaction to take a range of remedial steps including divestiture or transfer of a business to restore competition; and
- (e) the National Tax Administration - the Japanese taxation authority.

When undertaking a buyout in Japan, the level of interaction to be expected from the relevant regulators usually depends on matters such as whether a company involved in the buyout is public or private, the industry involved (e.g., broadcasting, telecommunications and airlines are subject to strict investment thresholds, and entities in the financial sector may only invest within the limits of their license), and whether a foreign entity is the acquirer in the buyout.

## 5. How are buyouts typically undertaken in the private and the public markets?

### Private companies

As a general rule, private buyouts are typically negotiated between the parties and may be undertaken by way of a sale and purchase contract. Auctions of private companies are becoming increasingly common in Japan, especially in the case of target companies with a large enterprise value. Auctions of private companies are not governed by any legislation or rules.

### Public listed companies

Buyouts of listed companies (including privatizations by means of a management buyout, which have gained increasing public recognition in recent years) are subject to a range of rules under the FIEA.

These include the substantial shareholder rules (5% rule) which requires that a person who acquires a holding of more than 5% of the issued voting shares of a company listed on any stock exchange in Japan must file a substantial shareholding report within five business days after the acquisition.

Under the tender offer bid rules, the basic position is that a person seeking to acquire, in an off-market transaction, either:

- (a) more than 5% of a listed company's voting shares in aggregate from more than ten shareholders within a period of 60 days; or
- (b) more than one-third of the company's voting shares,

must submit a formal tender offer bid to all shareholders.

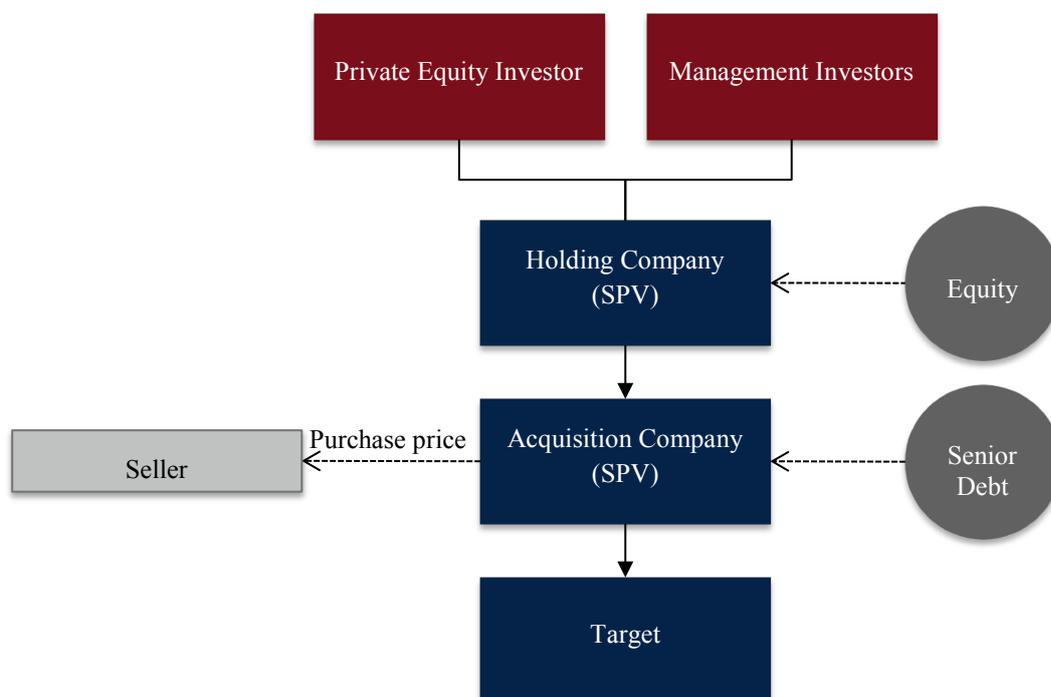
The tender offer may be subject to a minimum acceptance condition by which the offeror may withdraw the bid if the tender offer is under-subscribed. The tender offer may also be subject to a maximum acceptance condition (i.e., if an offeror receives acceptances in excess of the designated maximum number of shares, then the offeror may refuse to acquire the excess shares on a *pro rata* basis). However, an offeror is not permitted to include a maximum acceptance condition if it intends to purchase two-thirds or more of the voting shares of a listed company.

Under the insider trading rules, a person in possession of inside information commits the offence of insider trading if he or she buys or sells a public company's shares using material facts relating to the company's business before the company publicly discloses this information.

The FIEA also provides for several special disclosure regulations applicable only to management buyouts with the aim of protecting ordinary shareholders from potential conflicts of interests of the target management. These include disclosure of measures taken for ensuring the fairness of the purchase price. In addition, the Ministry of Economy, Trade, and Industry of Japan has issued non-binding guidelines for management buyouts (**MBO Guidelines**) as safe harbor rules. The MBO Guidelines set out recommended actions to be taken by the target and the acquirer to ensure the fairness of the transaction (including the target forming an independent consultation committee and obtaining a third party valuation report the acquirer offering a longer tender offer window period, and a prohibition against excessive deal protection arrangements).

## 6. What is the typical corporate structure used when doing a buyout?

Acquisition structures vary depending on the nature and complexity of the transaction. A typical structure for an acquisition of a non-listed company would involve the use of a structure as shown below:



Under this structure, the private equity fund and management investors contribute equity to the special purpose acquisition vehicle (Acquisition Company SPV) through a holding company.

In most cases, management investors contribute equity on or after the closing of the acquisition to avoid actual conflicts of interests between the target company and management investors. The lenders provide acquisition finance to the Acquisition Company.

Larger more complex deals may involve more complex structures, particularly if the acquisition finance involves mezzanine funding sources that may need to be structurally subordinated to the senior financiers but rank ahead of any equity contributed by the private equity fund or funds.

It is common for the target to be merged upstream into the Acquisition Company post-acquisition to secure the resource of repayment for senior loan facilities.



## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

The principal documents produced in a buyout include:

- (a) a share purchase agreement or business transfer agreement;
- (b) a senior loan agreement; and
- (c) security agreements for various security interests created over the target company's assets.

Terms and conditions among the private equity investors and management are generally set out in a shareholders agreement, a management agreement and a stock option agreement or other contract providing a performance incentive for management.

### Banking

The main banking documents include:

- (a) the senior loan agreement;
- (b) the mezzanine loan agreement;
- (c) an intercreditor agreement (if more than one level of debt financing is obtained); and
- (d) security agreements creating various security interests over the target company's or group's assets.

## 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

### Share purchase agreement

#### *Representations and warranties*

The forms of contractual buyer protection depend on the type of transaction and whether the transaction is between domestic parties only or involves a foreign buyer. In the latter case, the forms of protection requested are often influenced by the practice prevailing in the buyer's home market.

In a domestic transaction, there are some common forms of protection requested. For example in a share acquisition, the form of protection most commonly requested by the buyer is representations and warranties in relation to the target's business and assets, supported by an indemnity from the seller. If the acquisition is leveraged, the buyer typically requests a warranty that the target company's assets are legally disposable.

#### *Price adjustment mechanisms*

In a business transfer, where the period between signing and completion is typically longer than is the case with a share acquisition, the buyer typically requests a price adjustment to reflect changes between signing and completion. The price adjustment is usually a working capital adjustment but this will depend on the purchaser's valuation method. In a share acquisition deal, where the period between signing and completion is typically shorter, the buyer will not usually request a price adjustment, but instead takes into account the risk of material change between the due diligence and completion phases of the transaction in pricing the company.

## Shareholders agreement

The forms of protection usually sought in a shareholders agreement include:

- (a) having a majority of board seats;
- (b) requiring prior consent on making, or a reporting obligation concerning any major decision;
- (c) restrictions on share transfer, including the right of first refusal, tag-along and drag-along rights;
- (d) equity ownership in case of management's retirement or death; and
- (e) setting a target date for an initial public offering (IPO).

## Management agreement

The forms of protection usually sought in a management agreement are:

- (a) an agreement on the exercise of voting rights (as management would acquire some equity as a performance incentive);
- (b) a covenant to achieve target earnings before interest, taxes, depreciation and amortization or long-term business plan;
- (c) a management obligation to secure board approval of a fund's exit by trade sale or secondary buyout (share transfer in a closed company requires board approval);
- (d) management remuneration; and
- (e) a non-compete clause.

## 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

The portfolio company managers owe the company's shareholders non-contractual fiduciary duties (duty of care and duty of loyalty). To avoid direct conflicts of interest in Japan, portfolio company directors generally do not take managerial positions or acquire equity in the acquiring company until closing.

There have been several lawsuits by a target company's shareholders against management for breach of directors' fiduciary duties in a management buyout where the courts recognized minority shareholders' claims that the price offered for their shares was unfair. The MoF has since issued the MBO Guidelines that provide guidance in relation to this issue.

## 10. How are the equity arrangements typically regulated in a buyout?

Equity arrangements in a typical buyout are regulated primarily by a shareholders agreement. Additionally, the relevant company's articles of incorporation may include specific share rights attaching to the relevant classes of share to be issued or transferred.

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

Japanese law provides for class shares that potentially offer considerable flexibility in terms of the types of equity security that can be issued and the level of rights tailoring that can be adopted.



Funds typically prefer common stock, which enables them to easily control and exit portfolio companies. However, funds also take convertible instruments such as convertible bonds and stock subscription options. Preferred stock is often taken in corporate restructuring and turnaround deals.

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

The corporate form most commonly used for purposes of conducting business in Japan is a joint-stock corporation or *kabushiki kaisha* (**KK**). However, Japanese law also provides for a relatively new form of business vehicle analogous to a US limited liability company, called a *godo kaisha* (**GK**). The GK is a hybrid entity that is a combination of a company and a partnership (it functions internally like a partnership but the members' liability is limited).

### Board constituency

#### KK

A KK can be a single director company but more commonly has a board of three directors or more. In either case, a KK must have at least one representative director resident in Japan (but who need not be a Japanese national).<sup>16</sup> A KK with a board of directors must also have at least one company auditor (or a board of at least three company auditors, if a listed company), unless the KK has adopted a committee system of governance.

A KK that has adopted the three-committee system of governance (a corporation with committees (*iinkai secchi kaisha*)) has the following board level committees:

- (a) audit committee;
- (b) nomination committee; and
- (c) compensation committee.

Each committee must have at least three directors, the majority of whom must qualify as outside directors under the Japanese Companies Act (**Companies Act**). Unlike the traditional corporation with a board of directors, in a corporation with committees, the board of directors has a primarily oversight function, while the day-to-day business is executed by the executive officers appointed by the board of directors.

Amendments to the Companies Act due to come into force in May 2015 will add the corporation with an audit and supervisory committee (*kansa-to-iinkai secchi kaisha*) as a further option among the range of governance models. This model will feature one board level committee, the audit and supervisory committee<sup>17</sup> which must be comprised at least three directors, a majority of which must qualify as outside directors under the Companies Act.

#### GK

A GK does not have any directors but is managed by members (*shain*) who hold equity interests in the GK. Each member has the right to manage the GK, but 'executive members' (*gyōmu-shikkō shain*) may be appointed to operate and manage the GK if provided for in the articles of incorporation.

<sup>16</sup> Note however, that discussions are ongoing with the Japanese government to abolish this residency requirement.

<sup>17</sup> To more clearly distinguish between this model and the Corporation with Committee model, both of which embody a committee system, the name of the Corporation with Committees model will be changed to *shimei-iinkai-to secchi kaisha* (loosely translated as 'corporation with nomination and other committees', however the official English translation of the new form has yet to be confirmed).

It is possible for a legal entity (i.e., a corporation, including a foreign company) to become an executive partner, as long as the legal entity appoints an individual, referred to as the 'executive manager', to represent it. Although not specifically stipulated in the Companies Act, it is possible for a foreign company to be the sole partner of a GK. In that scenario, it is necessary for the foreign company to appoint an individual as the executive manager to represent it. The executive manager representing the foreign company must be a resident of Japan but need not be a Japanese national. However, where there is more than one executive manager, only one executive manager is required to be a resident of Japan. The executive manager owes fiduciary duties to the GK similar to those that a director would owe a KK.

### Differential director voting rights

Japanese law does not permit differential director voting rights. Each director has only one vote.

### Appointment and removal of directors

In a buyout, the private equity fund generally controls board composition and decision-making through its ownership of the target. As long as the private equity fund holds a majority of the target's voting stock, the rights of the private equity fund will be secured under Japanese statutory corporations law. However, in those cases where the private equity fund does not secure majority control, it may also secure the right to appoint and remove directors through the shareholders agreement and through rights attaching to class shares.

## 13. What measures are commonly used to give a fund some level of control over key operating and financial decisions made by an investee company?

Control over key operating and financial decisions made by an investee company is generally provided in the shareholders agreement, by which the private equity has the following rights:

- (a) the right to appoint one or more directors to the board of the portfolio company;
- (b) rights to receive financial and operating information on a regular basis; and
- (c) specific consent or veto rights over particular decisions of the portfolio company, including decisions that relate to operating or financial matters.

## 14. What employment terms are generally imposed on management in a buyout?

Management of portfolio companies is usually appointed to the company's board. The relationship between a Japanese company and its directors is legally not one of employment but of entrustment.

However, private equity funds often require management to enter into a management agreement, which, in addition to the terms set out in question 7, typically includes the following:

- (a) description of position;
- (b) term of office;
- (c) remuneration (including incentive plan);
- (d) non-competition/non-solicitation;
- (e) confidentiality; and



- (f) drag-along rights/call option exercisable by private equity funds (if management is not party to the shareholders agreement).

## 15. What incentives can be offered to management and how are they typically structured?

The most commonly used management incentives are shares and options. Ratchets are not commonly used in the market but cash earn-outs are sometimes used.

## 16. How are buyouts typically debt financed and secured?

### Lending

While it varies from transaction to transaction, typically between 60% and 70% of the cost of an acquisition is provided from debt provided by banks and financial institutions. The amount of debt that can be raised is typically calculated as a multiple of the earnings of the target business. Japan has a large number of domestic and international banks and financial institutions willing to participate in leveraged finance deals.

Lenders expect the equity to be structurally subordinated to the debt finance with the debt being lent to a special purpose finance company that is a wholly-owned subsidiary of the holding company.

### Security

Debt providers typically request security over all, or substantially all, of the borrower and/or target group's assets. However, there is no system for registering security interests created by companies in Japan. The Japanese system focuses on the nature of the asset provided as security rather than the entity creating the security interest. Therefore, security must be granted on an asset-by-asset basis.

Lenders usually consider a range of assets including shares in group companies, inventory, insurance claims, rental deposits, intellectual property, receivables, promissory notes, bank deposits, and real property.

One alternative to asset-by-asset security is for the parent company of the Japanese target to grant a pledge over the Japanese target's shares. As there is no concept of financial assistance in Japan, pledges can be more easily granted in Japan than in many other common law and civil law jurisdictions where financial assistance is an issue. Generally, a share pledge need not be a complicated document and does not necessarily need to be registered. It is perfected by the pledgee taking possession of the share certificates.

In reviewing a target's assets, lenders may need to assess on an asset-by-asset basis the relative complexity of taking security over a particular asset or asset category (including perfection procedures), the cost of perfecting the Japanese security, and the approximate time it would take to perfect the security.

Other forms of quasi-security, such as contractual or structural subordination, are also recognized under Japanese law and can be used when structuring the debt financing of a buyout.

## 17. Are there financial assistance issues to consider when undertaking a buyout?

Under Japanese law, there is no direct prohibition against a company providing financial assistance in connection with the acquisition of shares in itself or its parent company.

A company may theoretically provide financial assistance (i.e., loans, guarantees or security) in connection with the acquisition of its shares or its parent company's shares. In practice, however, a target company will not provide any financial assistance to the acquirer, unless and until it is wholly-

owned by one or more shareholders, each of whom is a party to the acquisition (see the answer to question 18).

If a subsidiary of the target company is wholly owned by its parent company at the time of the share purchase, that subsidiary may provide financial assistance concurrently with the acquisition. If the target company is owned by more than one shareholder and most shareholders are party to the share purchase transaction(s), including in the case of a takeover bid, neither the target company nor its subsidiaries will provide financial assistance until the completion of squeeze-out procedures.

## **18. What are the implications under the corporate benefit laws of Japan for a company providing financial assistance?**

The concept of corporate benefit relates to the ‘duty of care’ provided under Article 330 of the Companies Act and Article 644 of the Civil Code or the ‘duty of loyalty’ of the directors provided under Article 355 of the Companies Act, which stipulates that directors are required to act for the benefit of the corporation. Since the ultimate beneficiaries of the company are its shareholders, it is generally understood that any actions that do not harm the interests of the shareholders will not violate the duty of care and duty of loyalty. There is an argument that the directors’ duty of care and loyalty should also be owed to the creditors of the company, but this argument has not gained much traction.

Accordingly, a target company will not, in practice, provide financial assistance where only some of its shareholders are selling their shares. If a target company were to provide financial assistance for a sale of less than all of its shares, the transaction could prejudice those shareholders who do not sell their shares, and by doing so, constitute a violation of the directors’ duty of care and loyalty. Therefore, financial assistance is only provided after all of the target company’s shares have been acquired.

Conversely, if each of the target company’s shareholders is party to the share purchase transaction, then the target company may provide financial assistance concurrently with the acquisition.

## **19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?**

In Japan, secured creditors are not subject to bankruptcy procedures. They can exercise their rights by selling the secured property, through court auction or by voluntary sale outside the bankruptcy process, with the consent of all other secured creditors with an interest in the property.

The general order of priority within bankruptcy procedures after the payment of the bankruptcy trustee’s costs and taxes is:

- (a) employment claims;
- (b) unsecured creditors; and
- (c) shareholders.

Debt providers have priority over equity holders.

## **20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?**

### **Stamp duty**

Share purchase agreements are not subject to stamp duty in Japan.



Japanese stamp duty is, however, assessed on agreements for the acquisition of business assets (including real property, intellectual property rights, etc.) that are prepared and executed in Japan. Stamp duty rates are progressive and are assessed on the amount of the purchase price stated in the agreement. The maximum amount of stamp duty payable is JPY 600,000 on an agreement involving a purchase price of more than JPY 5 billion.

## Income tax and withholding taxes

### *Domestic LPS and NK structures*

In relation to domestic structures, both the LPS and NK are fiscally transparent entities for Japanese tax purposes for both domestic and foreign investors.

Domestic investors must pay income tax on their share of the LPS or NK profits.

Foreign investors that are deemed to have a taxable presence (a permanent establishment) in Japan through their participation in the domestic LPS or NK would generally be taxable at full corporate rates on their share of income attributable to their activities through the LPS or NK. Additionally, the general partner must withhold tax on any LPS or NK distributions made to a foreign LPS or NK member at the rate of 20.42%.

Foreign investors that do not have a permanent establishment in Japan, either by virtue of their participation in the domestic LPS or NK or otherwise are only subject to normal withholding tax rules on dividends (and deemed dividends) received from a Japanese company through the LPS or NK, and may only be required to pay tax on capital gains under special circumstances (e.g., if the LPS or NK have derived gains on the sale of a Japanese business subject to relief under the applicable bilateral tax treaty).

A foreign limited partner of a domestic LPS is exempt from Japanese income tax (including capital gains tax) by filing certain tax forms with the Japanese tax authority if it satisfies the following conditions:

- (a) the foreign limited partner must not be involved in the fund's operation (i.e., must be a passive investor);
- (b) the foreign limited partner's ownership in a domestic LPS must be less than 25%;
- (c) the foreign limited partner must not be in the same corporate group of the GP of the LPS; and
- (d) the foreign limited partner must not have a permanent establishment in Japan.

### *Foreign LPS structure*

In the case of foreign structures, a foreign LPS is generally fiscally transparent for Japanese tax purposes, and tax is imposed on the investors. A domestic investor must pay tax in Japan on its share of total LPS profits.

A non-Japanese investor without a permanent establishment in Japan is normally subject to withholding tax on the gross amount of any dividends received through the LPS from a Japanese company, and may only be required to pay tax on capital gains under special circumstances (such as where the gains are derived by the LPS on the sale of a Japanese business). If the tax authorities deem that the offshore LPS creates a permanent establishment, its members in Japan, all of the LPS members (including foreign members) are taxable at full Japanese rates on their share of LPS income. Additionally, the tax authorities may require the LPS general partner to withhold tax on distributions the LPS makes to offshore limited partners.

### *TK structure*

The TK is fiscally transparent for both domestic and foreign investors. Domestic investors pay corporation tax at standard domestic rates (around 36%) on their share of TK profits. Foreign investors meanwhile are generally subject to withholding tax at the rate of 20.42% on all TK distributions. Note that investors with a permanent establishment in Japan are taxable at full Japanese corporate rates of around 36% subject to domestic withholding tax credit. Under domestic principles, the Japanese tax authorities do not usually assert that a foreign investor has a taxable presence in Japan by virtue of participation in a TK arrangement alone. However, the risk of the authorities asserting that the foreign investor has a permanent establishment in Japan in any particular case should be considered in light of the specific TK arrangement.

Some investors have taken the position that Japanese withholding tax on TK distributions to offshore investors earned by foreign TK investors could be lawfully avoided where the offshore taxpayer could apply a favorable bilateral tax treaty. A favorable tax treaty is one containing an ‘other income’ clause i.e., a treaty clause stating that income not categorized elsewhere in the treaty is taxable only in the (foreign investor’s) country of residence. By characterizing the TK distributions as ‘other income’, the offshore taxpayer could assert that TK distributions are not taxable in Japan, and therefore not subject to Japanese withholding tax. Considering recent Japanese court cases and trends, however, it is likely that using this type of treaty clause to avoid withholding tax on TK distributions will trigger tax authority scrutiny. Investors would generally be advised to investigate carefully before investing through a TK arrangement.

## **21. What forms of exit are available?**

Where the investee company is solvent, private equity funds typically use trade sales and IPOs to realize their investments in Japan. Secondary buyouts are also a major exit option.

The advantage of a trade sale is that it usually gives the selling fund(s) a 100% exit. Until the recent recovery of the Japanese stock markets, trade sales were the favored option.

The disadvantages are that a trade sale usually has an ongoing (but limited) contingent exposure for warranties and indemnities negotiated with the buyer and is potentially exposed to price adjustments not found in IPOs.

The advantages of an IPO are that listing on a major exchange can enhance business reputation and prospects, there is no contractual warranty or indemnity risk, and there is potential for a higher earnings multiple. IPOs however require management time and effort, and funds often do not achieve a 100% exit from the investment on listing.

In terms of a secondary buyout, a fund can achieve 100% exit and it is generally easier to negotiate warranties and indemnities as the buying fund would understand the selling fund’s issues and also have management on its side.

Where the investee company is insolvent, funds generally do their best to turn around the company but typically seek to, as a last resort, cut their loss as much as possible through a trade sale. Bankruptcy is not a recognized option in Japan. The decision to sell a poor performer, and at what price, usually depends on factors such as how much life is left in the fund and overall portfolio performance.



## Luxembourg

### 1. What structures do private equity funds typically use to manage their funds?

#### General

The typical investment fund structures available for private equity and venture capital investments in Luxembourg are:

- (a) the Specialized Investment Fund (**SIF**); and
- (b) the SICAR or the SOPARFI (each of which qualifies as an alternative investment fund (**AIF**) if an alternative investment fund manager (**AIFM**) has been appointed).

SIFs, SICARs and SOPARFI-AIFs each must be restricted to ‘qualified’ investors (typically those investing at least EUR 125,000 or falling within the MiFID’s Annex II ‘professional investor’ category).

For most Luxembourg corporate or partnership structures, Luxembourg law provides that investors in SIFs, SICARs and SOPARFIs are not liable for the debts and obligations of those structures beyond the amount of their commitments. Interestingly, the new partnership law has even repealed the possibility of third party creditors claiming a limited partner claw-back when a distribution has been made beyond the actual profits generated.

Each of these structures is discussed in more detail below.

#### *SIF*

The SIF is a regulated collective investment scheme that is not subject to corporate income tax but does require a prior approval from the *Commission de Surveillance du Secteur Financier (CSSF)*. The objective of a SIF must be the collective investment of funds with the aim of spreading the investment risks and providing the partners with the benefit of the results of the management of their assets. A SIF can invest in any type of asset but it is subject to an asset concentration limit. This means that the SIF cannot invest more than 30% of its total assets or total investor commitments in securities of the same kind issued by the same issuer (making the SIF regime unsuitable when fewer than three portfolio companies are targeted by the fund manager).

#### *SICAR/SOPARFI*

For the most part, SICARs and SOPARFIs are created in the form of a partnership limited by shares (*Société en Commandite par actions*) (**SCA**), common limited partnership (*Société en Commandite Simple*) (**CLP**) or special limited partnership (*Société en Commandite Spéciale*) (**SLP**).

The objective of a SICAR must be the collective investment in securities representing risk capital to provide the partners with the benefit of the investment. The SICAR is not a collective scheme and therefore has access to double tax treaties as a normal taxable entity. The advantage for a private equity manager in using a SICAR is that, in contrast to a SIF, a SICAR is not subject to any risk-spreading rules. This means that there is no need for the private equity fund manager to create a large and diversified asset portfolio, therefore allowing it to focus its investments on narrow sectors. Similar to the SIF, the SICAR requires prior regulatory approval.

A SOPARFI (abbreviation of *Société de participations financières*) is a common form of Luxembourg holding company that may carry out any activities that fall within the scope of its corporate object clause. It may take the form of a public limited company (*Société Anonyme*) (**SA**), a private limited liability company (*Société à responsabilité limitée*) (**SARL**) or an SCA, CLP or SLP as described

above. Of these, the most commonly used Luxembourg private equity vehicle for a SOPARFI is the CLP.

### SLP

Further, with the implementation of the Alternative Investment Fund Management Directive (AIFMD), Luxembourg has introduced the SLP, which is a new partnership with no legal personality, the special limited partnership. This new legal form provides a modernized legal framework for the organization of the general partner/limited partner relationship. It is comparable to a UK limited partnership and can be set up under a specific regulatory wrapper regime (such as the SICAR or SIF regimes), or separately. When structured properly, the CLP/SLP structure is entirely tax transparent.

## 2. Do funds need to be licensed by any regulatory authority to conduct business in Luxembourg?

The implementation of the AIFMD in Luxembourg means that private equity managers must register as AIFMs and create AIFM companies that, in turn, are subject to prior approval and on-going supervision by the European regulators.

The 'passport system' introduced by the AIFMD has provoked a new trend of using unregulated 'quick-to-set-up' AIFs in the form of pure holding companies (which benefit from the use of the EU passport for the marketing of their shares/units/interests). In comparison to a SIF or a SICAR (where no marketing can in principle be done before CSSF approval of those regulated AIFs), the advantage of using a SOPARFI-AIF is to accelerate the time-to-market of those unregulated AIFs while benefitting from the full AIFMD regime via the passporting regime.

Note that a SOPARFI-AIF that appoints an AIFM and a depositary, and markets on the basis of an offering document (including the mandatory list of disclosures provided under Article 23 of the AIFMD) does not have to be regulated (in the sense that it does not need to have prior authorization).

## 3. Are there any approvals required for investments by foreigners in Luxembourg and, if so, what is the process?

Luxembourg does not have any requirements in relation to prior notification of a foreign investment in Luxembourg nor any specific laws that control currency exchange.

Companies performing commercial, craft or industrial activities do, however, need a business license, granted by the Ministry of Economy.

Further, certain specific regulatory controls or approvals relating to specific industries or activity may be required (e.g., credit institutions, insurance companies, investment firms and companies operating in the telecommunication business may be subject to specific approvals and notifications in certain cases).

## 4. Who are the relevant regulators in Luxembourg and how much interaction would one generally expect when undertaking a buyout?

The primary regulatory authorities in Luxembourg in a corporate context are:

- (a) the *Commission de Surveillance du Secteur Financier (CSSF)* – the primary regulator of financial services and listed companies;
- (b) tax authorities - the *Administration des Contributions Directes* (for direct tax) and *Administration de l'Enregistrement et des Domaines* (for VAT purposes); and
- (c) the *Ministère des Classes Moyennes (Ministry of Economy)* - if the Luxembourg target is an entity requiring a business license to carry out a commercial activity.



Interaction with other Luxembourg regulatory authorities largely depends on the nature of the transaction and the parties concerned (e.g., whether the buyout involves competition/antitrust issues, whether the acquirer is a foreign party and whether the transaction requires a prior approval).

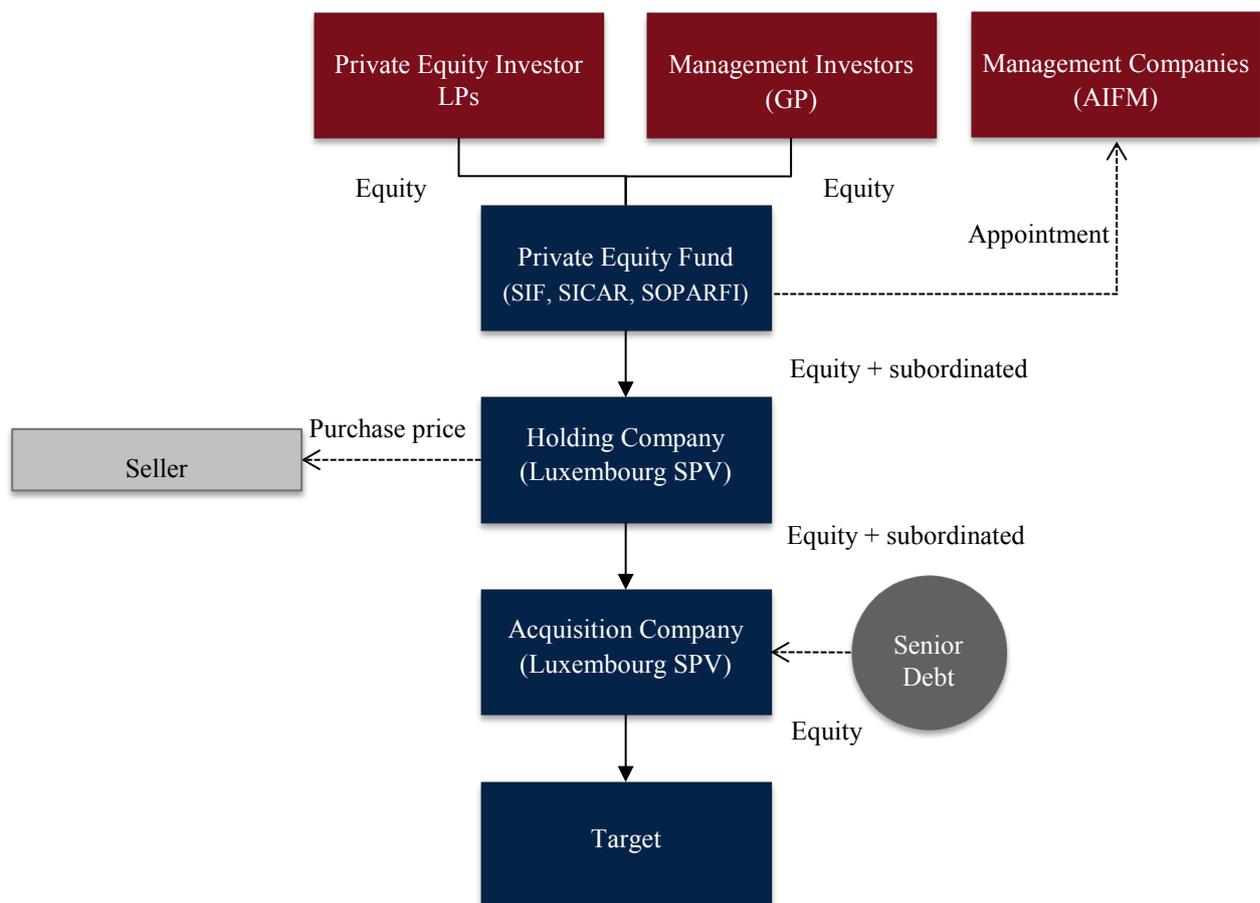
## 5. How are buyouts typically undertaken in the private and the public markets?

In a private context, transactions are usually undertaken by way of negotiated acquisition. That is, sale and purchase documents are prepared, negotiated and executed and those documents record the terms of the sale and acquisition and the rights and liabilities of the parties.

In a public context, buyouts are generally concluded by way of a takeover bid or acquisition of a block of shares.

## 6. What is the typical corporate structure used when doing a buyout?

Although acquisition structures do vary from transaction to transaction, it is fairly common to see a holding company structure adopted along the following lines:



As mentioned in the answer to question 1, various corporate forms can be used for SICARs, SIFs and SOPARFIs, most commonly an SA or a partnership in the form referred to in the answers to questions 1 and 2 (i.e., the SCA or, more commonly, the CLP, which is becoming increasingly popular because of its flexible legal regime under Luxembourg corporate law).

Unlike other corporate forms, the CLP can be formed by simple private deed without having to be notarized. Further, the CLP enjoys legal personality and its limited partner interests can be listed. There is a high degree of contractual freedom in settling the partnership agreement. For example, the

transferability of the interest can be freely determined, disclosure of the limited partners is not required, and all of the typical private equity provisions that are common under Delaware, Cayman or UK partnerships can be included. For example:

- (a) there is no rule regarding the apportionment of voting rights referable to the number of shares/interests held - i.e., the allocation of profit sharing and voting rights can be freely determined;
- (b) the general partner's 'divorce' clause, with or without cause;
- (c) selling restrictions; and
- (d) voting powers of limited partnerships are restricted to the amendment of the corporate object of the company, change of nationality, conversion of the company and winding-up of the company.

Luxembourg SPVs (being either the Holding Company/Acquisition Company and any further SPVs in the chain) are commonly incorporated in the form of SARLs.

## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

#### *Private context*

For a buyout negotiated in a private context the primary legal document that records the transaction is the sale and purchase agreement.

A shareholders agreement is also entered into between the limited partners and the members of the management team who become shareholders of the Holding Company/Acquisition Company (SPV).

The modernized partnership law allows for the shareholders' contractual arrangements to be inserted directly in the constitutional documentation of the Luxembourg partnership (i.e., the limited partnership agreement) and still benefit from complete privacy since the limited partnership agreement is not made public in the Luxembourg companies register.

There may also be other ancillary transaction documents prepared depending on the nature of the deal. These can include a separate representations and warranties agreement (if the representations and warranties are not provided for in the sale and purchase agreement) and a transition/shared services agreement.

#### *Public context*

For a buyout in a public context the corporate documentation to be prepared depends on whether the transaction is undertaken as a takeover bid or as the acquisition of a block of shares. When there is an acquisition of a block of shares, the primary document negotiated between the bidder and the majority shareholder(s) of the target is a sale and purchase agreement. This records the agreement of the parties in relation to the acquisition of the block of shares and the terms on which they have agreed to do so (including any conditionality). In the case of a takeover, the primary document for the bidder is a notification to the CSSF. This notification includes certain prescribed disclosures, together with the terms of the offer by the bidder.



## Banking

### *Lending*

The main banking document for a buyout is the senior facilities agreement under which the senior debt facilities are documented. The loans are typically amortizing and non-amortizing term loans with working capital lines and, in some instances, capital expenditure or acquisition facilities.

### *Subordinated or mezzanine finance*

If there is subordinated or mezzanine debt (the terms are interchangeable in the French market), there is typically a separate facility agreement under which that debt is made available and an intercreditor or subordination agreement recording the respective rights of the senior and subordinated/mezzanine lenders.

### *Security*

Security is usually held by a security agent for the lenders. An agency clause is included in the senior facilities agreement or, as the case may be, in the intercreditor or subordination agreement.

The senior facilities agreement also usually contains a guarantee granted by the target companies, in the light of corporate benefit and financial assistance issues. These companies cross-guarantee their obligations to the lenders.

The types of security interests typically granted are set out in separate documents.

## **8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?**

In a private context, buyer protections usually take the form of negotiated representations and warranties from the seller (being either the shareholder(s) in a share sale) or from the company from which the business and assets are being acquired along with a suretyship or a collateral arrangement granted by the seller. The terms of the warranty coverage vary from transaction to transaction, however, it is quite usual to expect that limits be placed in relation to that coverage, including claim thresholds and caps and time limits and adjustments for items otherwise disclosed or accounted for. Buyers sometimes place a portion of the sale proceeds in escrow for a period, or might seek bank guarantees from the seller. Warranty & indemnity insurance is not commonly used in Luxembourg.

## **9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?**

There are specific laws in Luxembourg requiring private equity fund managers to monitor and manage conflicts of interest.

The Commission Delegated Regulation (EU) No 231/2013 directly applicable in Luxembourg (as is the case for the other EU member states) specifies certain situations where a conflict of interest is likely to occur, in particular, where there is a prospect of financial gain or an avoidance of financial loss, or where financial or other incentives are provided to steer the behavior of the fund manager in such a way that it favors particular interests at the expense of the interests of other parties.

In general terms, all reasonable steps must be taken to avoid conflicts of interest and, if conflicts cannot be avoided, managers must identify, manage and monitor, and where applicable, disclose, those conflicts of interest in order to prevent them from adversely affecting the interests of the fund and its investors.

The rules can be summarized as follows:

- (a) procedures and measures must be established for the prevention or management of conflicts of interest;
- (b) there must be segregation of conflicting duties typically oversight functions (compliance, audit) from the operational units;
- (c) the remuneration policy must ensure that conflicts of interest are prevented and that undue influence on the employees is prevented; and
- (d) disclosure of conflicts of interest must be made to investors.

In a typical management buyout, it is worth mentioning the following rules that derive from the AIFMD:

- (a) a private equity fund manager must develop adequate and effective strategies for determining when and how any voting rights held in the fund portfolio companies it manages are to be exercised, to the exclusive benefit of the fund concerned and its investors; and
- (b) there are notification requirements to the competent authorities as well as information and disclosure requirements applicable in cases of control over non-listed companies or issuers (except small and medium-sized enterprises). This means that the fund must make the policy for preventing and managing conflicts of interest<sup>18</sup> available to:
  - (i) the relevant target company;
  - (ii) the shareholders of the relevant target company; and
  - (iii) the competent authorities.

## 10. How are the equity arrangements typically regulated in a buyout?

The equity arrangements in a typical buyout are regulated primarily in the limited partnership agreement (when using the form of a CLP or SLP) or in the constitutional document and/or shareholders agreement (when using the form of an SA or SCA for a SIF, SICAR and SOPARFI).

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

Great flexibility exists under Luxembourg law in relation to rights tailoring among different stakeholders. There can be different classes of shares, segregated shareholdings, tracking stocks (i.e., shares that track the performance of a particular asset by way of contractual provisions) and preferred shares (although preferred shares are sometimes replaced by specific rules contained in the limited partnership agreement (which is enforceable against the limited partners with the same constraints as share classes)). The manager may be granted a specific class of shares for the purposes of carried interest.

In short, the only limitation is the prohibition on depriving a limited partner from sharing in any profit.

---

<sup>18</sup> In particular between the AIFM, the AIF and the company (including information about the specific safeguards established to ensure that any agreement between the AIFM and/or the AIF and the company is concluded at arm's length).



## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

The laws in relation to the appointment, removal, composition and rights of the directors and approval committees of a company depend on the corporate form of the fund. For most Luxembourg corporations, the appointment and removal of directors can be freely determined and these rights are enforceable. In relation to voting rights, in the context of a private equity fund, each member of the management board has equal voting rights, although the chairman may have a casting vote in order to avoid dead-lock situations. It is common to choose a partnership structure where the general partner entity has controlling power over the management of the fund that it may exercise solely.

## 13. What measures are commonly used to give a private equity fund some level of control over key operating and financial decisions made by a portfolio company?

This type of control is generally obtained via the shareholders agreement/limited partnership agreement and is commonplace. It will be secured by the private equity fund having, under the shareholders agreement:

- (a) the right to appoint one or more directors to the board of the portfolio company;
- (b) certain rights to receive financial and operating information on a regular basis; and
- (c) specific consent or veto rights in relation to particular decisions of the portfolio company, including decisions that relate to operating or financial matters.

## 14. What employment terms are generally imposed on management in a buyout?

The members of a management team in a buyout are generally employees of the target company. However, key members of management may only be officers of either the target company or the Holding Company/Acquisition Company, not both.

Employment agreements are generally for an unlimited period whereas key managers are appointed as officers for a fixed term. It is also common for remuneration under these agreements to include a fixed component and a bonus component referable to performance. Golden parachute arrangements are also used in certain circumstances. Equity incentives offered to management are very often structured via a carried interest vehicle in Luxembourg.

## 15. What equity incentives can be offered to management and how are they typically structured?

Share classes are the typical way to incentivize management. The new AIFMD remuneration rules often apply providing for bonus deferral rights etc. The investor alignment is often realized by the creation of a carried interest vehicle by which management is invited to co-invest without any employer subsidies *pari passu* with the limited partners.

## 16. How are buyouts typically debt financed and secured?

The types of security interests typically granted in Luxembourg are determined by the assets the different group companies own and the corporate benefit/financial assistance issues. Note that there is no mechanism creating a security interest over all assets of a company such as a UCC filing in the U.S. or a floating charge in the UK. However, the following security interests may be available:

- (a) pledges over shares, receivables, bank accounts, movable assets and stock, and intellectual property rights;
- (b) mortgage over real property (*hypothèque*);
- (c) security assignment agreements; and
- (d) general recognition of close-out netting agreements (even if subject to foreign law).

## 17. Are there financial assistance issues to consider when undertaking a buyout?

### Financial assistance restrictions

Article 49-6 *et seq.* of the law of 10 August 1915 (as amended) relating to commercial companies (**Companies Law**) regulates the provision of financial assistance by a Luxembourg company. Financial assistance in the Grand Duchy of Luxembourg is permitted but restricted since the repeal of the prohibition on a Luxembourg company providing financial assistance in 2009.

The rule is that a company may directly or indirectly advance funds or make loans or provide security with a view to the acquisition of its shares by a third party subject to the restrictions set out below. The acceptance of the company's own shares as security either by the company itself or by a person acting in his/her own name, but on behalf of the company, is also treated as an acquisition falling under the financial assistance limitation.

The legal framework expressly applies to SAs and European companies (*sociétés européennes*) (pursuant to Article 49-6 of the Companies Law), and SCAs (pursuant to Article 103 of the Companies Law). The Companies Law does not have any specific rule on financial assistance applicable to SARLs.

Financial assistance may not take place unless:

- (a) the board of directors or the management board takes responsibility for ensuring that these transactions take place under fair market conditions, especially in relation to interest received by the company and security provided to the company for the loans and advances referred to above. The credit standing of the third party or, in the case of multiparty transactions, of each counterparty involved in the transaction must have been duly investigated;
- (b) the transactions must be submitted by the board of directors or the management board for prior approval to the general meeting of shareholders deliberating under the same conditions as for amendments to the articles of association (i.e., with a quorum of at least half of the share capital present or represented and a majority of two-thirds of the votes). The board of directors or the management board must present a written report to the general meeting of shareholders, stating the reasons for the transaction, the interest of the company in entering into the transaction, the conditions of the transaction, the risks involved for the liquidity and solvency of the company and the price at which the third party is to acquire the shares. The report must be lodged at the Luxembourg Register of Commerce and Companies and be published in the *Mémorial C* (Luxembourg official gazette for companies);



- (c) the aggregate financial assistance granted to third parties must at no time result in the reduction of the net assets of the company below an amount equivalent to the share capital, plus undistributable reserves. Furthermore, an undistributable reserve equivalent to the amount of the aggregate financial assistance must be booked in the liabilities of the company; and
- (d) where a third party, through the financial assistance of a company, acquires that company's own shares or subscribes for shares issued in the course of an increase of the share capital, that acquisition or subscription must be made at a fair price.

## Special report

If:

- (a) members of the board of directors of a company;
- (b) the management board of a company;
- (c) members of the board of directors of a parent company;
- (d) members of the management board of a parent company;
- (e) the parent company itself; or
- (f) third parties acting in their own name but on behalf of:
  - (i) the company;
  - (ii) the members of the board of directors; or
  - (iii) the management board,

are party to a transaction where there is financial assistance then the supervisory auditor (*Commissaire aux comptes*) or the statutory auditor (*réviseur d'entreprise*) must provide a special report on the transaction to the general meeting of shareholders who will vote on that report. (A 'third party' is any legal or natural person, i.e., any true third party or a parent company (either direct or indirect), individual shareholders, creditors or employees.)

## Exemptions for banks, employees and investment companies

The above restrictions do not apply to transactions concluded by banks and other financial institutions in the normal course of business, or to transactions effected with a view to the acquisition of shares by or for the employees and staff of the company. However, even in this case, the relevant transaction must at no time result in the reduction of the net assets below an amount equivalent to:

- (a) the share capital; *plus*
- (b) undistributable reserves.

The financial assistance limitation will also not apply to the acquisition of fully paid-up shares issued by an investment company with fixed capital and acquired at the investor's request by that company or by a person acting in his/her own name by on behalf of that company.

## Consequences for breach

A person or entity that breaches the rules set out above is subject to criminal law. Under Article 168 of the Companies Law, any person acting in his/her capacity as director of a company who makes loans or advances using company funds or shares or other interests in the company contrary to rules of Articles 49-6 and 49-7 of the Companies Law relating to financial assistance will be subject to a jail term of one month to two years and/or a fine between EUR 5,000 to EUR 125,000.

Providing security in breach of the financial assistance limitations, however, is not a criminal offense even if made in breach of the Companies Law.

## 18. What are the implications under the corporate benefit laws of Luxembourg for a company providing financial assistance?

Directors of a Luxembourg company are liable to the company under general law for the performance of the mandate given to them and for any misconduct in the management of the company's affairs. They are also jointly and severally liable both to the company and any third parties for damages resulting from any breach of the Companies Law or the articles of association of the company.

Whenever a director has a conflict of interest in relation to a transaction in which the company is involved and in relation to which the board of directors will vote, that director must notify the board of the conflict. The relevant director must make a record of the notified conflict in the minutes of the meeting and the director must not take part in the relevant deliberations nor vote.

Directors may also face civil liability for mismanagement in addition to the criminal penalties stated in the answer to question 17.

Furthermore, any director who in bad faith:

- (a) makes use of the assets or the credit of the company which he/she knew was contrary to the company's interests, either for personal purposes or for the benefit of another company or undertaking in which he/she was directly or indirectly interested in; and
- (b) makes use of their powers or votes they could cast in their capacity as director which is contrary to the interests of the company either for personal purposes or for the benefit of another company or undertaking in which they have a direct or indirect interest,

faces a potential jail term of one to five years and/or a fine in the amount of EUR 500 to EUR 25,000.

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

The Luxembourg civil code provides the rank and order of priority among creditors of a company. Shareholders of a Luxembourg company always, in their capacity as shareholders, rank below all other creditors of the company. They can only be repaid out of liquidation proceeds.

However, shareholders may also grant financing to a Luxembourg company. Debt financing granted by shareholders may be made through hybrid instruments (in which case they are generally contractually subordinated to other creditors of the company) or through pure debt instruments. In that case, their rank as creditor depends on:

- (a) the security granted to them; and
- (b) contractual subordination provisions (failing which, they will be treated as ordinary creditors).

Luxembourg law differentiates between 'privileged' and 'ordinary' creditors. Privileged creditors have a priority ranking over all assets of the debtor due either to mandatory legal provisions (such as claims for salaries by employees or claims by the tax administration) or securities recognized as having priority by law by which certain assets are reserved to the beneficiaries of the security (e.g., a pledge agreement or mortgage).

Privileged creditors will be paid in priority taking into account their rank. Those creditors having the same rank are paid their claim *pro rata* out of the assets concerned. Privileged creditors benefiting from the same type of security will rank according to:



- (a) the date of registration of the security; or
- (b) the date when the security became enforceable against third parties.

Ordinary creditors will be paid out of the remaining assets (if any) once all of the privileged creditors have been satisfied.

Beneficiaries of a pledge agreement over financial assets as provided in the law on financial collateral agreements (**Financial Collateral Law**) have a right of retention, so that even privileged creditors such as employees or the tax administration cannot be paid prior to the relevant beneficiary in relation to the pledged asset(s). Financial collateral agreements subject to the Financial Collateral Law will be enforceable against the receiver in insolvency (*curateur de la faillite*) or liquidator (*liquidateur*) even if created on the day when the insolvency or liquidation proceedings were commenced and in certain limited circumstances, even after the commencement of those proceedings.

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

### General

The Luxembourg tax environment is extremely beneficial for private equity structures, both regulated and unregulated. For example, a two-tier Luxembourg structure (a Luxembourg-based regulated or non-regulated fund in the form of a CLP or SLP owning a Luxembourg SOPARFI, the business activity of which is holding and financing various SPVs) is commonly adopted for tax reasons, flexible cash flow and to facilitate multiple fund raisings.

The key benefits to expect from a Luxembourg based regulated or non-regulated fund in the form of a CLP or SLP is tax transparency (when properly structured, they are not subject to Luxembourg tax) and the facilitation of multiple fund raisings as mentioned above.

The key tax benefits applicable to a SOPARFI are:

- (a) the Luxembourg participation exemption regime on dividends, liquidation proceeds, capital gains and net wealth tax (subject to certain holding and threshold conditions);
- (b) availability of the full double tax treaty and EU directives; and
- (c) no withholding tax on interest payments (or on payment of a liquidation bonus, if any).

Where investments held by the SOPARFI would not benefit from any particular tax exemption under Luxembourg domestic legislation or under double tax treaties concluded with Luxembourg, then straight loans or specific debt instruments can be used to shelter taxable income.

### Financing the investment held by a SOPARFI

#### *Deductibility of financing expenses*

In general, interest expenses on unrelated or third-party debt (i.e., bank debt) used to finance the investment are fully tax-deductible for Luxembourg corporate income tax purposes.

However, there can be limits on the tax deduction of interest expenses on related party debt in the case of excessive debt financing. In particular, please note:

- (a) expenses, including interest expenses and write-downs, in direct economic relation with a shareholding held by a SOPARFI are non-deductible for tax purposes up to the amount of an exempt dividend derived during the same financial year. On the other hand, expenses exceeding the amount of the exempt dividend received from that shareholding during the

same financial year remain deductible for tax purposes. This excess may create tax losses to carry forward without a time limit;

- (b) the ‘recapture rule’ by which any capital gains realized on the disposal of shares are not tax exempt for an amount corresponding to the excess of the expenses related to the shareholding that reduced the tax base of the SOPARFI in the year of disposal or in the previous financial years. In other words, the exempt amount of the capital gain realized by a SOPARFI on the disposal of a participation qualifying for the capital gain exemption is reduced by:
  - (i) the interest expenses incurred on a loan financing the shares sold (wholly or partly) that were deducted in the year of the disposal or in the previous financial years; and
  - (ii) any deductible write-down recorded on the shares sold (wholly or partly) in the year of the disposal or in previous financial years.

For a SOPARFI whose only activity is to hold participations, the ‘recapture’ of those expenses is neutral from a tax perspective since these expenses should have created corresponding tax losses that can be carried forward without a time limit, and which would offset the taxable portion of the capital gain;

- (c) the thin capitalization rules by which the debt/equity ratio applicable to a fully taxable Luxembourg capital company is 15:85 (equity: aggregate liabilities). Within this limit, interest on debt paid or accrued is tax-deductible and payments are not subject to Luxembourg withholding tax. If this ratio is exceeded, interest in relation to the excess of liabilities can be re-qualified as dividends for tax purposes. The consequence is that the interest in excess is not deductible and withholding tax could apply depending on the country of residence of the recipient<sup>19</sup>;
- (d) the ‘arm’s length principle’ by which all transactions between related entities should be conducted on an arm’s length basis. Therefore, the remuneration on a loan between related parties should be at arm’s length. If, however, the interest expenses are not on arm’s length terms, the Luxembourg authorities may adjust the reported figures in a tax return and the interest expenses in excess of the arm’s length interest expenses would not be tax-deductible and would also qualify as deemed dividend distributions. Note that the Luxembourg tax authorities have issued a circular in relation to the tax treatment of inter-company financing transactions. The circular aims to provide clear rules regarding the scope of the determination of the arm’s length character to international groups engaged in inter-company financing transactions, and it generally refers to OECD transfer pricing guidelines.

#### *Withholding tax on interest*

Luxembourg does not levy any withholding tax on interest.

#### *Income tax*

Net income less deductible expenses (i.e., interest expenses, depreciation, etc.) is subject to corporate income tax and municipal business tax at a rate of 29.22%. In particular, please note:

- (a) the tax exemption under the Luxembourg participation exemption regime. In general, dividends and liquidation proceeds received by a SOPARFI are subject to corporate income tax and municipal business tax at an aggregate rate of 29.22%. However, the income received from a ‘qualifying shareholding’<sup>20</sup> (QA) may be exempt under the Luxembourg participation

---

<sup>19</sup> Unless reduced rate provided by an applicable double tax treaty or exemption under Luxembourg participation exemption regime.

<sup>20</sup> A qualifying shareholding is: (a) an entity covered by article 2 of the amended Council Directive of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (2011/96/EU); (b) a Luxembourg resident fully taxable ‘share capital



exemption regime provided that, at the date the income is placed at the disposal of the SOPARFI, the latter holds or commits to hold the QA for an uninterrupted period of at least 12 months and, throughout that whole period, the shareholding represents at least 10% of the share capital of the QA or its acquisition cost amounts to at least EUR 1.2 million;

If these requirements are not met, a 50% tax exemption is still granted at the SOPARFI level if the distributing company is:

- (i) a Luxembourg resident fully taxable ‘entity’;
  - (ii) a collective entity which is a resident of a country with which Luxembourg has concluded a double tax treaty and which is fully subject to a tax corresponding to Luxembourg corporate income tax (statutory income tax of at least 10.5%); or
  - (iii) an entity covered by Article 2 of the amended Council Directive of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (2011/96/EU);
- (b) in principle, capital gains realized by a SOPARFI on the disposal of shares in another entity are subject to corporate income tax and municipal business tax at an aggregate rate of 29.22%. However, capital gains deriving from shares held in a QA would be exempted from Luxembourg corporate income tax and municipal business tax under the same conditions as those required for dividends exemption except that the minimum acquisition cost of the shares is increased to EUR 6 million;
- (c) double tax treaties and well-tailored tax structuring can lead to more favorable tax requirements;
- (d) a tax loss can be carried forward for an unlimited period of time after the year during which the loss was incurred. Only the taxpayer who incurred the loss can deduct this loss; and
- (e) transaction costs will be deductible but subject to recapture rules, or be part of the acquisition price of the shares.

#### *Distribution of profits made by the SOPARFI*

Dividends paid out from a SOPARFI are generally subject to a Luxembourg withholding at a rate of 15% unless benefiting from an exemption under Luxembourg domestic tax law or a reduced rate under a double tax treaty concluded with Luxembourg.

Under Luxembourg law and more particularly under Article 147 of the Luxembourg Income Tax Law, dividends paid out from a SOPARFI can be exempt from Luxembourg withholding tax provided that the beneficiary is a ‘qualifying shareholder’<sup>21</sup> (QS) and that at the date the dividends are placed at the disposal of the QS, the QS:

---

company’ not listed in the appendix of paragraph (10) of article 166 of the Luxembourg income tax law; or (c) a non-resident ‘share capital company’ fully subject to a tax corresponding to Luxembourg corporate income tax (this condition should be in principle met if the foreign company is subject to a statutory income tax of at least 10.5%).

<sup>21</sup> A qualifying shareholder is: (a) an entity covered by article 2 of the amended Council Directive of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (2011/96/EU); (b) a Luxembourg resident fully taxable ‘share capital company’ not listed in the appendix of paragraph (10) of article 166 of the Luxembourg income tax law; (c) a collective entity which is a resident of a country with which Luxembourg has concluded a double tax treaty fully subject to a tax corresponding to Luxembourg corporate income tax (i.e., statutory income tax of at least 10.5%); (d) a permanent establishment of a collective entity referred to previously; (e) a Swiss resident ‘share capital company’ which is effectively subject to a corporate income tax in Switzerland without benefiting from an exemption; (f) a Luxembourg permanent establishment of a ‘share capital company’ which is resident in a

- (a) holds or commits to hold its shareholding in the SOPARFI for an uninterrupted period of at least 12 months; and
- (b) throughout that whole period, the shareholding represents at least 10% of the share capital of the SOPARFI, or its acquisition price amounts to at least EUR 1.2 million.

In the case of a two-tier Luxembourg structure, the regulated or non-regulated Luxembourg based fund will be disregarded for Luxembourg tax purposes (because of its tax transparency).

The analysis in relation to whether the beneficiary of the dividends paid out from a SOPARFI can be considered to be a QS needs to be made at the upper level of the structure.

## 21. What forms of exit are available?

In a solvent situation the most common forms of exit are an IPO or a trade sale (either a sale of shares or a sale of the underlying business). Secondary buyouts are becoming more common (i.e., sale by a private equity fund to another fund, either a general fund or a secondary fund).

---

State with which Luxembourg has concluded a double tax treaty; (g) a corporation or cooperative company which is resident of an EEA country other than an EU Member State and which is liable to a tax corresponding to the Luxembourg corporate income tax (i.e., at least 10.5%); or (h) a permanent establishment of a corporation or cooperative company which is a resident of an EEA country other than EU Member State.



## Malaysia

### 1. What structures do private equity funds typically use to manage their funds?

The structure commonly used by private equity funds to manage the funds raised from their investor base in Malaysia is the limited partnership that is commonly constituted in Labuan (a federal territory off the coast of Borneo in East Malaysia) or the Cayman Islands for tax purposes. The investors hold limited partnership interests in the partnership and there is a general partner who takes day-to-day management control of the partnership and its operations.

The fund typically enters into a fund management agreement with a local fund management company to advise on the fund management activities of the fund in Malaysia.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in Malaysia?

A private equity fund does not need to be licensed in Malaysia.

The public offering of units in a fund is a form of securities offering in Malaysia that is regulated by the Capital Markets and Services Act 2007.

A fund management company needs to obtain a capital markets services license from the Securities Commission (SC) to carry out fund management activities in Malaysia. Persons who carry out fund management activities for the fund are also required to obtain a representative's license from the SC to carry out the fund management activities.

### 3. Are there any approvals required for investments by foreigners in Malaysia and, if so, what is the process?

#### Foreign investment restrictions

Generally, investments made by foreigners in Malaysia are not subject to the approval of any governmental or regulatory agency in Malaysia except for companies in certain regulated industries (which involve restrictions on foreign shareholding) such as banking, insurance, aviation, telecommunications, energy and infrastructure. In these circumstances, there are sectoral regulations by the relevant government ministries and/or agencies restricting the transfer of shares, foreign shareholding equity and/or share capital requirements of these companies.

#### Exchange controls

The Malaysian foreign exchange rules have been consolidated into seven Foreign Exchange Administration notices (**FEA Notices**) which supplement the foreign exchange administration rules under the Financial Services Act (**FSA**) and Islamic Financial Services Act (**IFSA**).

The FEA Notices prescribe the circumstances in which the specific approval of the Controller of Foreign Exchange within the Central Bank of Malaysia (**Bank Negara**) must be obtained by 'residents' and 'non-residents' to remit funds to and from Malaysia. For these purposes:

- (a) 'resident' is defined as a citizen of Malaysia (excluding a person who has a permanent residence in a foreign country and resides outside Malaysia), a non-citizen of Malaysia who has obtained permanent resident status in Malaysia and is residing permanently in Malaysia, or a party (body corporate or unincorporated) incorporated or registered with, or approved by, any authority in Malaysia; and

- (b) 'non-resident' is defined as any person/party other than a resident, an overseas branch, an overseas subsidiary, a regional office, a sales office, a representative office of a resident company, embassies, consulates, high commissions, supranational or international organizations, or a Malaysian citizen who has obtained permanent resident status in a territory outside Malaysia and is residing outside Malaysia.

The following are some of the provisions and restrictions of the FEA Notices applicable to residents and non-residents.

*Settlements between residents and non-residents*

Residents and non-residents are free to settle payments for import and export of goods and services in foreign currency. Settlement in Malaysian Ringgit is allowed as long as:

- (a) the payment by a resident is made into the external account of the non-resident (i.e., an account in Ringgit maintained with financial institutions in Malaysia); or
- (b) payment by a non-resident is effected from an external account (of that non-resident or any other non-resident).

In relation to other settlements, residents are free to make payments to non-residents in foreign currency, except that the payment for investment in foreign currency assets is subject to prevailing rules on investment in foreign currency assets. Resident future brokers may make payments in foreign currency to a non-resident for foreign currency-denominated derivatives (other than exchange rate derivatives) transacted on overseas specified exchanges.

Residents may pay non-residents in Ringgit for:

- (a) the purchase of Ringgit assets;
- (b) settlement of trade in goods;
- (c) settlement of services;
- (d) income earned or expenses incurred in Malaysia;
- (e) settlement of a commodity '*murabahah*'<sup>22</sup> transaction between the parties undertaking transactions via a resident commodity trading service provider;
- (f) settlement of reinsurance for domestic insurance business or *retakaful*<sup>23</sup> for domestic *takaful*<sup>24</sup> business;
- (g) settlement of a non-financial guarantee denominated in Ringgit issued by a person licensed to undertake banking business in Labuan; or
- (h) for any other purposes as long as the non-resident is an immediate family member.

---

<sup>22</sup> A cost-plus-profit financing in which a buyer and seller enter into a sale of commodities agreement by which the buyer purchases the commodities from the seller at a price covering the seller's purchase price plus profit margin agreed on by both parties concerned and after which the buyer has the option to sell the commodities to a third party.

<sup>23</sup> An arrangement consistent with sound *takaful* principles for *retakaful* of liabilities in respect of risks incurred or to be incurred by the *takaful* operator in the course of his carrying on *takaful* business.

<sup>24</sup> A scheme based on brotherhood, solidarity and mutual assistance which provides for mutual financial aid and assistance to the participants in case of need and by which the participants mutually agree to contribute for that purpose.



### *Borrowing in Ringgit*

Resident companies may borrow:

- (a) any amount from non-resident entities within its group and non-resident direct shareholders to finance activities in the real property sector in Malaysia; and
- (b) up to MYR 1 million in aggregate from any other non-residents, other than a non-resident non-bank company or individual, for use in Malaysia.

Non-residents may borrow from licensed onshore banks, as well as resident stockbroking companies and resident insurance companies for specified purposes.

### *Borrowing in foreign currency*

A resident individual may borrow in foreign currencies up to an amount equivalent to MYR 10 million from a licensed onshore bank or a non-resident. Non-residents may borrow any amount of foreign currency from:

- (a) licensed onshore banks;
- (b) another non-resident in Malaysia; or
- (c) any immediate family member.

Non-residents are also permitted to borrow from resident non-bank companies or individuals, subject to certain limits depending on whether it has existing Ringgit loans/facilities.

### *Lending in Ringgit*

Resident licensed onshore banks, resident non-bank companies and individuals are free to lend any amount to non-resident non-bank companies or individuals for the purpose of financing activities in the real property sector in Malaysia. Resident stockbroking companies and resident insurance companies are also allowed to lend to non-residents for specified purposes.

Non-resident non-bank related companies may lend any amount to their resident related companies to finance real property sector activities in Malaysia. Other non-resident non-bank companies or individuals may lend up to MYR 1 million in aggregate to resident companies or resident individuals for use in Malaysia.

### *Lending in foreign currency*

Non-resident non-bank related companies may lend any amount to their related resident companies. Other non-residents may lend in foreign currency up to an amount equivalent to MYR 10 million to a resident individual and up to MYR 100 million equivalent to a resident company on a corporate group basis.

### *Other*

Other exchange control rules apply to investments abroad i.e., the issue, transfer or substitution of securities or financial instruments, financial guarantees, export of goods, opening of foreign currency accounts, payments and hedging, as well as dealings with specified persons and companies.

## **4. Who are the relevant regulators in Malaysia and how much interaction would one generally expect when undertaking a buyout?**

The primary regulatory authorities in Malaysia in a corporate context are:

- (a) the Securities Commission (SC) – administers the statutory laws regulating capital markets;

- (b) the Bursa Malaysia Securities Berhad (**Bursa Malaysia**) – has frontline regulatory responsibilities over the securities and futures markets and the broker-dealers who trade on the exchange;
- (c) the Bank Negara Malaysia (**Bank Negara**) - monitors the conduct of financial institutions and exchange control in Malaysia;
- (d) the Malaysian Competition Commission (**CCM**)– for competition issues arising from acquisitions;
- (e) the Companies Commission of Malaysia – monitors corporate compliance with disclosure requirements imposed on companies and businesses and regulates public accountants performing statutory audits; and
- (f) the Inland Revenue Board of Malaysia – taxation authority.

The level of expected involvement with the SC, Bursa Malaysia and Bank Negara in a buyout situation depends to a large extent on whether the transaction involves a public company or a private company. Transactions involving public companies (such as a public takeover) generally result in greater interaction with the stated authorities than a transaction involving a private acquisition.

Interaction with the other authorities depends to a large extent on the nature of the transaction and the parties concerned.

## 5. How are buyouts typically undertaken in the private and the public markets?

### Private companies

In relation to private companies, a buyout is generally undertaken by way of a private acquisition that is concluded after negotiations between the parties. The parties negotiate and execute a sale and purchase agreement that records the terms and conditions of the acquisition as well as the rights and liabilities of the parties involved.

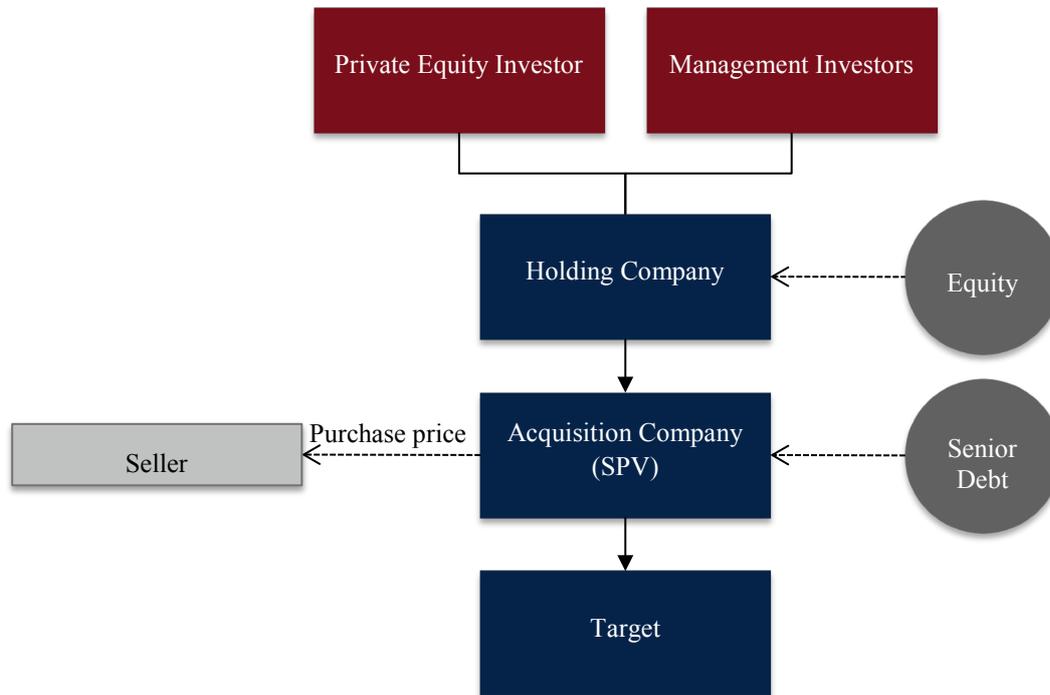
### Public companies

In relation to public listed companies, a buyout is typically undertaken by way of a takeover bid or by way of a scheme of arrangement, both of which must comply with applicable statutory provisions that govern the process of the takeover or scheme of arrangement, respectively.



## 6. What is the typical corporate structure used when doing a buyout?

The choice of the corporate structure used when undertaking a buyout is typically tax driven. Funds may undertake a buyout of a company directly or through an investment holding company. More elaborate structures are used on larger and more complex deals.



## 7. What transaction documentation is usually prepared when undertaking a buyout?

Typically, before negotiations begin for a buyout, the investor and the target company sign a confidentiality agreement.

Negotiation usually begins with the circulation of a term sheet or memorandum of understanding that is a summary of points agreed, or to be agreed, between the investor and the company.

After due diligence in relation to the target company is completed, the share purchase agreement, subscription agreement or investment agreement is executed by both parties. Typically, a shareholders agreement is also entered into by the investor, the target company and the existing shareholders of the target company if the company is not wholly-acquired.

Some other relevant documents that may be prepared when undertaking a buyout include employment agreements between key employees and the target company, employee share option plans, management or service agreements and a registration rights agreement.

## 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

A private equity fund usually seeks a full range of warranties and indemnities from the sellers and management as a form of buyer protection when undertaking a buyout. Part of the purchase consideration may be withheld or placed in escrow for a fixed period to meet any warranty or indemnity claim. Warranty & indemnity insurance is used in Malaysia, especially in the private equity context.

It is also common for a fund to set conditions precedent to the acquisition which need to be fulfilled (or not triggered) by completion.

## 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

There are no specific laws regulating how conflicts of interest should be managed in a typical management buyout. However, the Malaysian Companies Act 1967 (**Companies Act**) does impose general statutory obligations on directors to act honestly and use reasonable diligence in the discharge of their duties at all times. Further, directors may not engage in any improper use of any information acquired by way of their position in the company to gain an advantage for themselves, or for any other person, or cause a detriment to the company.

Directors also owe fiduciary duties to act in good faith and in the best interests of the company and not to put themselves in a position of conflict.

Management may also be in a position of conflict due to their contractual obligations to the company, and their service agreements typically impose obligations that have to be fulfilled. Management transaction protocol letters are used in Malaysia.

## 10. How are the equity arrangements typically regulated in a buyout?

The equity arrangements in a buyout are typically regulated by a shareholders agreement entered into by the existing shareholders of the company and the new investors. Further, the memorandum and articles of association of the company are often amended to include the specific share rights that attach to the relevant classes of security to be issued in relation to the buyout.

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

Generally, Malaysian law does not impose any restrictions on the classes of equity security that can be granted or the level of rights tailoring that can occur between different stakeholders in a buyout. Shares having any type of rights may be created as designated among the shareholders of the company. Typically, the classes of equity security include ordinary shares, preference shares or convertible debt instruments. Preference shares and convertible debt instruments are favored by venture investors.

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

Typically, the shareholders agreement sets out the relationships, rights and obligations among the investor, the target company and the existing shareholders of the target company. The shareholders agreement and the articles of association govern matters concerning board constituency, differential director voting rights and the removal of directors.

There is no provision in the Companies Act that prescribes the manner in which directors are to be appointed, except for the minimum appointment of two resident directors. There are certain exceptions for specific groups of people (e.g., undischarged bankrupts) who are not permitted to hold directorships.

The appointment and removal of directors is usually dealt with in the articles of association.



### 13. What measures are commonly used to give a private equity fund some level of control over key operating and financial decisions made by a portfolio company?

The fund usually has representation on the board of the company if it wishes to have a say in the management and direction of the company. Representation on the board may also include a presence on the audit and compensation committees. A shareholders agreement or the memorandum and articles of association of a company can entrench the fund's right to appoint a majority of members to the board for private limited companies.

The fund may create particular corporate governance and approval authority workflows to impose restrictions on management undertaking any fundamental matters (such as a major acquisition or disposal) or large projects without board approval.

### 14. What employment terms are generally imposed on management in a buyout?

Long-term agreements are entered into with key personnel of the target company to ensure continuity. Key employment terms include non-compete clauses, confidentiality clauses and provisions for 'gardening leave' to mitigate risks when key personnel resign. Incentive plans tied to company performance may also be introduced to ensure long-term retention of the management.

### 15. What equity incentives can be offered to management and how are they typically structured?

#### General

Generally, incentive plans for management are structured on a long-term basis. However, short-term incentives based on annual results are not uncommon. If the fund decides to take the company public, stock options (with or without lock-ups) are a typical incentive available.

#### Ratchet mechanisms

One common incentive employed to ensure that the management team is committed to the business of the company is the ratchet mechanism. This mechanism enables the relevant percentage of equity held by management and the fund to alter according to management's performance. It provides management with an incentive to increase or retain its equity in the company in proportion to how well it performs. The most frequently used ratchet mechanisms include the redemption of the fund's shares (where the fund takes a part of its equity in the form of redeemable shares) and variation of rights attached to shares (where the articles of association of the company may be drafted to provide for automatic variation of the rights attached to the fund's or management's shares on achievement of performance targets). It should be noted that the type of ratchet mechanism adopted is typically tax-driven.

### 16. How are buyouts typically debt financed and secured?

The debt structure generally consists of senior debt and mezzanine debt. The senior debt is usually made available by banks and financial institutions. The types of senior debt include term loans and revolving credit facilities. Mezzanine debt ranks behind senior debt but ahead of equity capital. It is usually injected by the fund providing the equity, the seller (if it wishes to maintain a minority interest) or a senior debt provider (in addition to the senior debt).

Security is typically obtained through the usual mortgages and charges (fixed and floating) over the acquired assets, or the shares acquired, subject to compliance with the financial assistance provisions

of the Companies Act. Usually, the relative priority of security depends on the contractual arrangements negotiated between the parties.

## 17. Are there financial assistance issues to consider when undertaking a buyout?

### General prohibition

Section 67 of the Companies Act prohibits the provision of financial assistance by a company for the acquisition of shares in that company or its parent company, subject to limited exceptions. Section 67(1) provides that no company shall give, whether directly or indirectly and whether by means of a loan guarantee or the provision of security or otherwise, any financial assistance for the purpose of, or in connection with, a purchase or subscription made or to be made by any person of, or for, any shares in the company or, where the company is a subsidiary, in its holding company, or in any way purchase, deal in or lend money on its own shares.

Nevertheless, there is judicial authority to support the principle that a *bona fide* transaction entered into in good faith will not be caught by Section 67(1). To determine whether a transaction is *bona fide*, the following matters, among other things, will be taken into account:

- (a) whether the transaction was entered into with the sole or substantial purpose of providing financial assistance to allow the acquisition of or subscription for shares in the company or its holding company;
- (b) whether the transaction was genuinely entered into for the company's benefit; and
- (c) whether the transaction results in a dissipation of the company's financial resources.

### Exceptions

Section 67(2) provides for limited exceptions to the general prohibition above. Under Section 67(2), nothing in subsection (1) shall prohibit:

- (a) where the lending of money is part of the ordinary business of the company;
- (b) the provision by the company, in accordance with any scheme for the time being in force, of money for the purchase of or subscription for fully paid shares in the company or its holding company, being a purchase or subscription by trustees of or for shares to be held by or for the benefit of employees of the company, or a subsidiary of the company, including any director holding a salaried employment or office in the company or a subsidiary of the company; or
- (c) the giving of financial assistance by the company to persons, other than directors, *bona fide* in the employment of the company or a subsidiary of the company, with a view to enabling those persons to purchase fully paid shares in the company or its holding company to be held by themselves by way of beneficial ownership.

Further exceptions include:

- (a) a court-ordered compulsory purchase of shares by the company in the event of oppression in disregard of members' interests or unfair discrimination or prejudicial conduct under Section 181 of the Companies Act;
- (b) the redemption of preference shares; and
- (c) the capitalization of a share premium account.



## Consequences

A company that fails to comply with the financial assistance restrictions set out in Section 67 is not guilty of an offense, though its officers, if found guilty, may be imprisoned for a period of up to five years or fined a sum of up to MYR 100,000 or both. Further, on conviction, a court may order the officer to make payment of compensation and the order may be enforced as if it were a judgment.

Significantly, nothing in Section 67 shall operate to prevent a company or person from recovering the amount of any loan made in contravention of the section or any amount for which it becomes liable, either on account of any financial assistance given, or under any guarantee entered into or in respect of any security provided in contravention of this section.

## Publicly listed companies

Notwithstanding the above, Section 67A of the Companies Act allows a publicly listed company with a share capital to purchase its own shares if authorized by its articles of association. In order to do so:

- (a) the public company must be solvent on the date of the purchase and must not become insolvent by incurring the debts involved in the obligation to pay for the shares so purchased;
- (b) the purchase must be made through Bursa Malaysia on which the shares of the company are quoted and in accordance with the relevant rules of Bursa Malaysia; and
- (c) the purchase must be made in good faith and in the interests of the company.

The company must also, within 14 days after the shares are purchased, lodge with the CCM and Bursa Malaysia a notice in the prescribed form.

A company, every officer of the company and any other person in default of Section 67A is guilty of an offense and subject to imprisonment for up to five years or a fine of up to MYR 100,000 or both.

## 18. What are the implications under the corporate benefit laws of Malaysia for a company providing financial assistance?

In Malaysia, directors of a company have a fiduciary duty to act in the *bona fide* interests of the company as a whole and not for any collateral purpose.

What constitutes the 'interests of the company as a whole' depends on the context in which it is used. It may include the interests of:

- (a) the company as a corporate entity;
- (b) the company's shareholders;
- (c) the company's creditors (where the company is unable to pay its debts); or
- (d) the interests of the company as a group.

Where a company is part of a group of companies, the general rule is that the directors of a company are to act in the *bona fide* interests of that company as opposed to the interests of other companies in the group or the group as a whole. Nevertheless, the courts have held that it is permissible for directors to consider the interests of the group as a whole insofar as these are not detrimental to the company itself or where the interests of the company are inextricably bound to the interests of the other companies in the group or the group as a whole.

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

Malaysian insolvency laws provide for a basic ranking of claims among debtors of the company.

The general law of property applies in these situations and secured creditors take priority over unsecured creditors. As between secured creditors, a legal charge prevails over an equitable charge (unless the equitable charge was created first and the legal chargee knew of the prior charge).

It should be noted that the Companies Act provides for a class of preferential creditors, such as employees whose wages or salaries are unpaid, that take priority over unsecured creditors in the event of a company winding up.

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

The tax structure of a fund depends on which form of entity it has chosen to adopt. If the form chosen is a company, the tax rate is currently 25%, while the personal income tax rates apply to a partnership. There is no capital gains tax in Malaysia.

Malaysia has tax treaties with many other countries to avoid double taxation of income earned in one country by a resident of another country. There is also reduction or exemption of tax on certain types of income provided in the tax treaties.

### Transfer tax

In general, in a share acquisition the buyer pays stamp duty of 0.3% of the purchase price paid or of the market value of the shares, whichever is higher. However, mutual agreement between the parties to allow the cost to be borne by either or both of the parties is possible.

On the transfer of land and buildings, *ad valorem* stamp duty at rates ranging from between 1% to 3% on the transfer consideration or the market value of the property, whichever is the higher, is payable.

### Withholding tax

Dividends paid to non-residents are not subject to withholding tax in Malaysia.

### Thin capitalization

Malaysia has thin capitalization legislation, however, implementation of the regime has been deferred to the end of December 2015 to allow the Malaysian government more time to assess its impact on foreign direct investments.

## 21. What forms of exit are available?

In solvent situations, the common forms of exit are via initial public offerings or trade sales to strategic investors or to another private equity firm. Dual track exits are not common in Malaysia. (The Malaysian securities regulator would raise queries and be likely to refuse to process the IPO application if there is an intention for an outright sale to be carried out).

In insolvent situations, the company may still be sold to another private equity firm or strategic investor if those parties believe that they can derive better value from the insolvent company. In certain situations, the insolvent company may be placed into voluntary or involuntary liquidation and shareholders are returned any cash remaining after the creditors are paid.



## Mexico

### 1. What structures do private equity funds typically use to manage their funds?

In general, funds are formed using foreign pass-through entities established and domiciled in jurisdictions with which Mexico has entered into a treaty to avoid double taxation (e.g., the U.S., Canada, the Netherlands, Belgium and Spain). In turn, the funds are managed by a fund manager established in Mexico.

The most relevant forms of business organizations commonly used to manage private equity funds to manage the investments in Mexico are:

- (a) corporations (*sociedad anónima (SA)* or *sociedad anónima de capital variable (SA de CV)*); and
- (b) limited liability companies (*sociedad de responsabilidad limitada (S de RL)* or *sociedad de responsabilidad limitada de capital variable (S de RL de CV)*).

There are several other available structures that may also be of interest to private equity funds, including:

- (a) a stock corporation (*sociedad anónima promotora de inversión (SAPI)* which is a special form of corporation with an intermediate structure between a fully private company and an entity that may go public (known as a SAPIB when it is going public (**SAPIB**) and a SAB when fully public (**SAB**)). It is regulated by the Mexican Securities Market Law (**Securities Market Law**);
- (b) a private equity investment trust which enjoys certain limited tax incentives under the Mexican Income Tax Law (FICAP); and
- (c) a real estate investment trust that also enjoys certain limited tax incentives under the Mexican Income Tax Law (FIBRAS).

### 2. Do funds need to be licensed by any regulatory authority to conduct business in the jurisdiction?

Generally funds do not need to be licensed by any regulatory authority to conduct business in Mexico, but it depends on the type of investment. For example, investments in any financial entity require prior authorization from the Ministry of Finance and Public Credit. Also, all publicly traded funds require authorization from the National Banking and Securities Commission and registration with the National Securities Registry.

Funds (local or foreign) do not need to be registered to operate in Mexico.

### 3. Are there any approvals required for investments by foreigners in the jurisdiction and, if so, what is the process?

As a general rule, foreign investors and Mexican companies controlled by foreign investors may, without prior approval:

- (a) own up to 100% of the equity of Mexican companies;
- (b) purchase fixed assets from Mexican persons;
- (c) engage in new activities or produce new products;

- (d) open and operate establishments; and
- (e) expand or relocate existing establishments.

However, there are limits on foreign investment participation set by Mexican law in relation to certain regulated businesses. The limited exceptions to the general rule are those expressly established in the Foreign Investments Law (**FIL**) and its regulations as set out below. Other than these specific limitations on foreign investments, the National Commission of Foreign Investments (**NCFI**) also needs to approve any proposed investment by foreigners in a company whose assets are worth the Mexican peso equivalent of USD 230 million.

## General notification requirements

### *Notifications to the National Commission of Foreign Investments (NCFI)*

The FIL and its regulations provide that companies with foreign investments (whether subject to approval or not) are required to file several notices regarding the operations of the companies' financial status and other relevant information with the NCFI.

Mexican companies with foreign investment are required to register with the NCFI within 40 business days of the date of their respective incorporation. That registration must be regularly renewed to maintain good standing. The requirement is to file a notice within 40 business days of any change with the NCFI, in the case of changes to the original information submitted to the NCFI. If a company does not comply with this requirement, it will be subject to administrative fines.

Mexican companies whose capital is held by foreign investors, in any amount, are required to file a corporate financial and statistical questionnaire with the NCFI for the corresponding latest fiscal year, once a year. In addition, any company with foreign investment in its capital must file, on an annual basis, a quarterly report within 20 business days of the end of each quarter.

### *Approval from the Ministry of Economy*

Under the FIL, a foreign company that intends to:

- (a) carry out commercial acts in Mexico on a regular basis, or
- (b) set up a presence in Mexico (and provided it is not subject to any specific sector regulations)

must obtain approval from the Ministry of Economy to establish and register a branch in Mexico. An application must be submitted to the Ministry which must rule on the application within 15 business days of the day on which the application was submitted.

## Industry-specific regulation

The FIL lists certain economic activities that are:

- (a) reserved to the Mexican State;
- (b) reserved to Mexican nationals or Mexican companies without foreign equity participation;
- (c) subject to quantitative foreign investment limitations, and
- (d) subject to prior approval if the foreign investor wishes to own more than 49% of a company engaged in those activities.

These are discussed below.



### *Activities reserved to the Mexican State*

In compliance with the Mexican Constitution and as a reflection of historical concerns regarding private investment, the FIL reserves certain strategic areas to the Mexican State. Neither Mexican nor foreign investors may engage in the following areas of economic activity:

- (a) exploration and extraction of petroleum and any other hydrocarbons;
- (b) planning and control of the national electricity system, as well as the transmission and distribution of electric energy public service;
- (c) radioactive minerals;
- (d) manufacture of coins and currency;
- (e) generation of nuclear energy;
- (f) the postal service;
- (g) telegraphic and radiotelegraphic services; and
- (h) management and control of ports, airports and heliports.

### *Activities reserved to Mexican investors*

The FIL establishes certain economic activities that are open exclusively to Mexican investors (Mexican nationals or Mexican companies with a foreign exclusion clause (*cláusula calvo*)). These activities include:

- (a) domestic and international transportation of passengers by land;
- (b) tourism;
- (c) freight/shipping cargo (excluding messenger and courier services);
- (d) development banks; and
- (e) professional and technical services reserved to Mexicans under the corresponding legislation.

Foreign investors cannot participate in any of the above activities, directly or indirectly, through any agreement or corporate structure or scheme, except by owning specially approved 'neutral' shares (which have no voting rights and limited corporate rights), or as otherwise approved by the NCFI.

### *Activities with foreign investment equity limitations*

Under the FIL, foreign investors may not own more than the permitted percentage of equity in a Mexican company engaged in any of the activities referred to below. The limits set out below may not be surpassed either directly or through any type of agreement or corporate structure or scheme, except via ownership of 'neutral' shares, and unless otherwise provided for by international treaty (e.g., North American Free Trade Agreement in the case of financial services):

- (a) cooperative production corporations (foreign investment is limited to 10%);
- (b) Foreign investment of up to 25% is permitted in national airline transportation, national air taxis, transportation and specialized air transportation.

### *Activities subject to pre-approval*

Under the FIL, a foreign investor may acquire more than 49% of the equity of an existing company owned by Mexican investors without the prior approval of the NCFI, provided the target company is not engaged in one of the restricted activities set out below, and the total value of the assets of that

company does not exceed certain monetary thresholds established annually by the NCFI (currently, this threshold is MXN 3,601,905,682.86).

Prior approval is required before a foreign investor can own more than 49% of a company engaged in any of the following activities:

- (a) port services to vessels engaged in interior navigation (e.g., towing, mooring);
- (b) overseas shipping;
- (c) companies authorized to operate public aerodromes;
- (d) private schools (preschool, primary, secondary, preparatory and higher levels);
- (e) legal services; and
- (f) construction, operation and use of railways and public railroad transport services.

Those foreign investors required to obtain prior approval to own 49%+ of a new or existing Mexican company must file an application with the NCFI, which has 45 business days from the day of the failing to issue its ruling. If the NCFI does not rule within 45 days, the application will be deemed approved.

#### 4. Who are the relevant regulators in the jurisdiction and how much interaction would one generally expect when undertaking a buyout?

The most relevant regulators include:

- (a) the Ministry of Finance and Public Credit and the National Banking and Securities Commission - review and approve the change of control and any relevant reorganization of financial institutions including banks and stock brokerage firms. The Central Bank (*Banco de México*), and the Mexican Stock Exchange also review and participate in this process;
- (b) the Ministry of Treasury and the National Insurances and Bonds Commission - review and authorize any change of control and any relevant reorganization of companies engaged in the insurance and bond businesses;
- (c) the Ministry of Communications and Transportation, together with the Federal Commission of Telecommunications and Federal Roads and Bridges - have relevant regulation and authorization jurisdiction in connection with buyouts of concessions or companies engaged in telephone communication, television, ports, airports, airlines, railroads, highways, transport and infrastructure in general;
- (d) the Federal Economic Competition Commission- has jurisdiction to receive notice or to approve acquisitions of shares or assets above a certain value or ownership percentage thresholds;
- (e) the National Commission of Foreign Investments (**NCFI**) - authorizes or is notified in connection with any foreign investment in general (as described in the answer to question 3); and
- (f) National Banking and Securities Commissions - regulates financial entities.

Note that there is no dedicated corporate regulator.



## 5. How are buyouts typically undertaken in the private and public markets?

### Private market

Private market transactions are regularly carried out through a negotiated acquisition. The negotiated acquisition is reflected in the acquisition documents that are prepared and that contain all relevant terms and conditions of the sale and purchase, and the rights and obligations of the parties.

### Public market

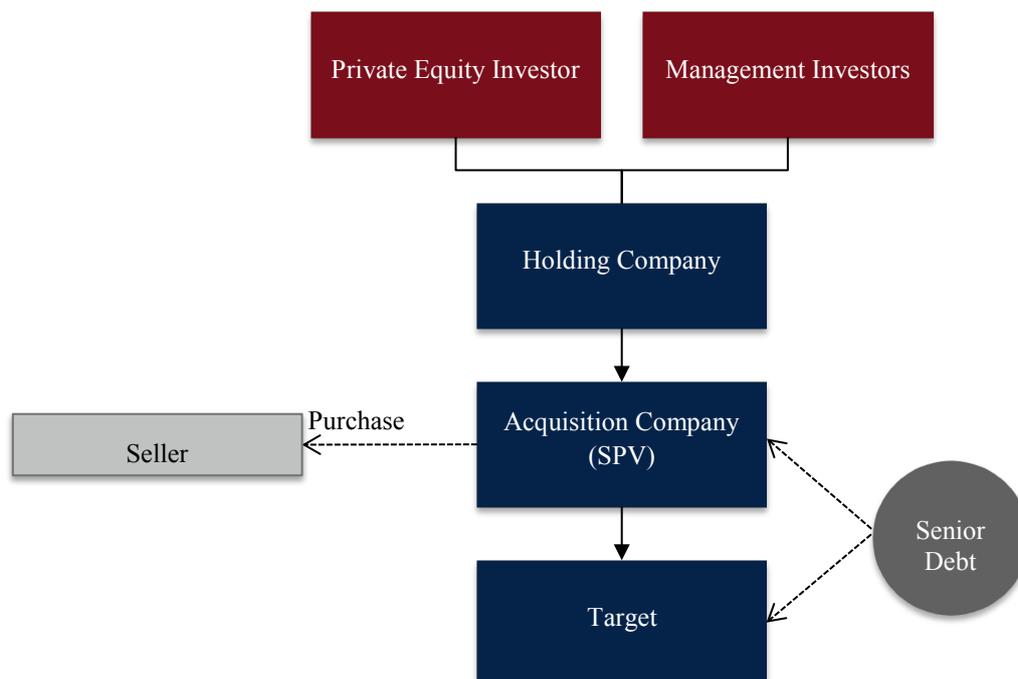
Public takeover offers are by no means a regular practice in Mexico. Nevertheless, Mexican law allows the acquisition of a controlling stake in a publicly held corporation through a public offer made to all the holders of the shares. It is common for a publicly held corporation's controlling stake to be negotiated and acquired through a private transaction because companies in the capital market in Mexico usually have a high percentage of their voting stock that is not publicly traded. (It is common for a certain amount of voting stock in publicly traded Mexican companies to not be publicly traded but be held by a controlling shareholder, therefore maintaining control over the company).

## 6. What is the typical corporate structure used when doing a buyout?

Although acquisition structures vary from transaction to transaction, it is fairly common to see a structure along the following lines:

Depending on the transaction, debt could also be provided directly into the target at closing. More elaborate structures exist on larger, more complex deals.

The holding company can be either a Mexican company or a foreign company. The corporate form of the company varies (i.e., it can be an SA, an S de RL, a SAPI, etc.) as described in more detail in the answer to question 11. When structuring LBOs in Mexico, it is important that acquisition financing is injected at the operating target company level for tax reasons (often there is a post-acquisition restructuring of the debt component).



## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

For a buyout negotiated in a private context the primary legal document that records the transaction is the sale and purchase agreement. There may also be other ancillary transaction documents prepared depending the nature of the deal. These can include, for example, a shareholders agreement, employment agreements, a transition/shared services agreement and stockholders resolutions including amendments to bylaws.

### Banking

The banking documents generally include standard banking credit agreements, bylaws, financial statements, promissory notes, a guarantee, collateral agreements, trusts and other documents as required, on a case-by-case basis.

## 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

Buyer protection is included in detailed representation, negotiated warranty & indemnity coverage, with thresholds and caps, time limits and price adjustments. Holdbacks or escrows are also used. Occasionally earn-out provisions, a mortgage, pledge or a guarantee trust may confer an additional comfort to buyers, and the seller may be willing to accept these provisions to conclude a deal.

In connection with liens, a search may be conducted in the Public Registry of Property (for real estate), the Public Registry of Commerce (for the company) and the Registry for Security Interests (for a pledge, financial lease, etc.).

## 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

### Private companies

The Commercial Companies Law provides that the board is an essential organizational body and is appointed at the shareholders' meeting to manage the corporation. This management function is carried out through one or more individuals called directors that may also be shareholders of the company or of non-related entities.

A director is an agent of the company and must act diligently and within the scope of authority conferred by the shareholders' meeting. The breadth of this management function is determined by the authority expressly conferred by the shareholders, company's charter and bylaws, and the law. This authority jointly conferred on the directors as a board is subordinated at all times to the authority of the shareholders' meeting.

Each director must comply with certain legal provisions under the Commercial Companies Law, including that:

- (a) a director's self-interest must be subordinated to the company's purpose and corporate opportunity if there is a conflict of interest. A director in a position of conflict must disclose the conflict of interest and refrain from voting on a resolution that may have an adverse effect on the company's business; and
- (b) the board must not exceed the scope of authority conferred by the shareholders' meeting unless the action is approved beforehand by the shareholders' meeting.



A director is liable for any damages and loss of profits caused to the corporation when acting outside his or her authority.

In the context of a management buyout of a private corporation there are no specific provisions regulating conflicts of interest but only these general principles as described. Certain provisions may be agreed on in executed contracts.

## Public companies

In the context of publicly-traded corporations:

- (a) directors must refrain from dealing with corporate stock of the public company in their own interest, or from releasing privileged and confidential information to a third party in order for the third party to undertake any position with respect to that corporate stock; and
- (b) directors must:
  - (i) not use corporate assets (movable, intangible or personnel) and property to conduct personal business;
  - (ii) not divulge company secrets or information in relation to its operations or business intentions; and
  - (iii) support the board in relation to advising on the company's operation, based on the analysis of the business growth and development, so that the board can adopt sustainable decisions.

## 10. How are the equity arrangements typically regulated in a buyout?

It is a recommended practice for equity arrangements to be included in the bylaws that are filed with the Public Registry of Commerce, as Mexican law considers the bylaws, above all other documentation, to be the governing rules of the company. These may be in addition to any private shareholders agreement, an agreement for the joint management and operation of a company or a joint venture agreement. Equity trusts may also be recommended under certain circumstances (e.g., if the shares of the company are to be transferred on certain default scenarios or if shares are pledged). Share certificates also include a brief abstract text on limitations in relation to free transfers of equity.

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

### SA/S de RL

A simple SA corporation that is regulated only by the Commercial Companies Law (with SAPIs and SABs being exceptions as described below) may only issue fully voting shares, preferred shares with restricted voting rights, and special employee shares that have further flexibility to freely regulate value, limitations on transfer and other restrictions that are rarely issued in practice.

S de RLs issue equity quotas instead of shares. Each partner holds one equity quota, which may be of different value in proportion to their contributions. For S de RLs, voting and participation in relation to dividends depends on the value of their equity quota.

### SAPI/SAB

A SAPI has the most flexibility and is able to issue shares without any voting rights at all, shares with voting rights only, non-proportional economic rights, and shares with veto rights or with other limitations or rights (e.g., designating board members and profit sharing).

Special shares with limited or restricted voting rights or even without voting rights may also be issued by a SAB with prior authorization from the National Banking and Securities Commission, and must not exceed 25% of the total equity unless a special public offering and conversion program is in place.

## Trusts

Other structures include a trust or controlling trust that issues units or certificates that may represent interests in a combination of shares (e.g., one unit that may represent one voting share and three non-voting shares), or other combinations that may be individually tailored.

### 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

There are few laws around board constituency. The Commercial Companies Law provides for certain minority rights protection (e.g., shareholders representing a 25% interest in the equity of an SA are entitled to appoint one member to the board of directors). This requirement is lowered to 10% for SAPIs, SAPIBs and SABs.

A board of directors may legally adopt resolutions in a meeting with the attendance of half of its members, and may adopt resolutions without a meeting by written consent of all of its members. The Commercial Companies Law provides the chairman of the board of directors with a casting vote in either an S de RL or SA.

A SAB is regulated by both the Commercial Companies Law and the Securities Market Law. The Securities Market Law includes special additional provisions regarding the constituency of the board of directors of a SAB, setting out a maximum number of 21 members, of which a minimum of 25% must be independent members (i.e., those members not having any direct or indirect economic interest in the company or relationship with other shareholders or their family members).

Further, note that Mexican law provides a requirement for a supermajority vote in the case of certain decisions (e.g. admission of new partners to an S de RL, the transfer of equity interests issued by an S de RL or the approval of any amendments to the target's bylaws). New minority rights could be agreed to by the shareholders and be incorporated in the bylaws of the company (i.e., approval is needed from a certain class of share).

### 13. What measures are commonly used to give a fund some level of control over key operating and financial decisions made by a portfolio company?

Measures commonly used to give a fund some level of control over key operating and financial decisions made by a portfolio company are usually included in the bylaws of the company and may include:

- (a) holding a relevant portfolio of shares in the controlling block of the portfolio company;
- (b) holding shares of a class that give its holders rights to veto or consent to relevant operating and financial decisions of concern (for example indebtedness or other financial ratios or covenants); and
- (c) execution of a shareholders agreement that may include provisions to receive certain financial and operative information considered relevant.

Sometimes measures also include the requirements for special majority votes to take action or approve resolutions on certain matters, and occasionally a controlling or managing trust agreement is executed to assure effective control in the administration of the company.



## 14. What employment terms are generally imposed on management in a buyout?

Employment arrangements with senior management and key employees in a buyout normally involve a variable portion of their total compensation being based on attainment of goals linked to the performance and profit margins of the company. An important part of senior management's total compensation is usually based on an equity-based plan.

This type of employment arrangement is normally agreed on in an employment contract for an indefinite term. Although sometimes a fixed employment period may be agreed, under applicable labor law, early termination without cause would trigger a more beneficial severance than the one payable under an indefinite term agreement.

Restrictive covenants like non-compete or non-solicitation obligations are difficult to enforce but are still worth considering including in the employment contract.

## 15. What equity incentives can be offered to management and how are they typically structured?

Incentives for management of portfolio companies generally take the form of equity. Senior management may participate in equity incentive plans, normally agreed separately from the employment contract. The most common types are stock option, stock purchase and restricted stock units plans. Management usually owns shares in these types of plans with a vesting period often matching the investment period in the company.

Granting and vesting periods may vary. However, certain events may trigger automatic vesting or forfeiture of equity incentive (i.e., change in control, termination of senior management, an initial public offering, etc.).

Normally, these types of plans are granted or sponsored by an entity different from the company acting as the employer of senior management. Mexican labor law is silent with respect to equity incentive plans and although normally granted by an entity different from the employer, they may be construed as being part of senior management's total compensation for the purposes of a severance calculation.

Put and call options over the underlying shares are typical when structuring the sale or purchase of equity options. Good leaver and bad leaver provisions may also be found in shareholders agreements. Usually distinctions are not made between a good and a bad leaver, but these may be agreed to by the parties in the bylaws of the company. Put and call options would regularly be subject to an agreed valuation method which usually would not be lower than the share's net worth value as determined in the last balance sheet.

## 16. How are buyouts typically debt financed and secured?

Financing depends on the specific valuation of the relevant transaction and market conditions. The amount of debt that may be raised is typically calculated as a multiple of EBITDA. There is no standard approach, however the majority of the cost of an acquisition generally comes from loans with banks, financial institutions and, to a more limited extent, from other private investors that may be interested in high yield secured lending or in the possibility of conversion of debt into equity at the agreed time. Both domestic and foreign financing from banks and financial institutions are available and may be used without any limitation but certain thin capitalization rules and tax withholdings may apply to foreign financing.

Typically lenders expect equity to be structurally subordinated to debt finance. Debt may be lent to a special purpose finance company that is a wholly owned subsidiary of the holding company or

directly either to the holding company or the operating entity. Depending on the requirements of the lending entity, the security may include a fixed, a floating or a mixed interest in assets of the entire transaction and may include shares with any relevant approval from shareholders that may be applicable or required.

## **17. Are there financial assistance issues to consider when undertaking a buyout?**

There are no specific rules or legal provisions in Mexico expressly prohibiting financial assistance, although the giving of financial assistance is uncommon in practice. A Mexican target company usually provides financial information to a potential buyer of its shares, or the shares of its parent company (either direct or ultimate), but does not normally provide financial advice or assistance to the potential buyer. Notwithstanding this, the convenience of providing financial assistance to the potential buyer should be assessed on a case-by-case basis, and if convenient, it could be done as long as the bylaws of the Mexican company would allow it.

There are certain financial assistance activities that can only be undertaken by banks and financial institutions in Mexico, although those activities may not be relevant to most transfers of shares in Mexico.

## **18. What are the implications under the corporate benefit laws of Mexico for a company providing financial assistance?**

The Commercial Companies Law establishes that the business operations and activities of a Mexican commercial company must be carried out in accordance with the company's corporate purposes, as established in its bylaws. Therefore, as long as the bylaws of the relevant company do not establish restrictions or prohibitions on providing financial assistance to a potential buyer of its shares, or the shares of its parent company (either direct or ultimate), the company will be entitled to enter into agreements to provide financial assistance. Those agreements should facilitate business or financing opportunities that would enable the company to comply with its business purposes and objectives as provided in its bylaws.

Although it is not mandatory under the Commercial Companies Law, it would be useful to have a shareholders' meeting approving the execution of, and compliance with, the agreements in relation to the financial assistance by the company, specifically for the potential buyer to proceed with the acquisition of the company's shares or the shares of its parent company (either direct or ultimate), and to have the corresponding shareholders waive their preferential rights to acquire the shares of the company that are to be sold to the potential buyer.

The Commercial Companies Law provides that the sole director or the board of directors of a company must act according to the provisions of its bylaws, and based on the decisions/instructions of the shareholders' meetings, always act with prudence and diligence, and consider the business of the company as if it was their own. Therefore, once the shareholders have approved the execution of, and compliance with, the agreements in relation to the financial assistance by the company, the sole director of the board of directors could execute that agreement on behalf of the company, unless of course the shareholders have designated another representative to execute the agreement.

## **19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?**

If the court declares the debtor to be insolvent, each creditor must file its own statement of claim. Then the creditors are classified by the court in the following order of priority:

- (a) uniquely privileged creditors (burial expenses and illness-related expenses (if the illness was the cause of death) of the debtor);



- (b) secured creditors with the benefit of a mortgage or a pledge;
- (c) creditors with special privilege (creditors referred to as such by the Commercial Code or other applicable laws); and
- (d) common (i.e., all other) creditors.

There is no establishment of a creditor's board, but any creditor or group of creditors that represents at least 10% of the claims will have the right to request the court to appoint an 'intervener' (the intervener will be designated by the court). The intervener has the right to access the accounts of the debtor, balance sheets, and any other document or information regarding the administration of the company that may affect the interests of the creditors.

Claims against the bankrupt estate are paid in accordance with the classification set out above, and in the following order of priority:

- (a) labor wages, expenses assumed for the administration of the bankrupt estate, expenses authorized by the trustee, expenses assumed for the security, maintenance or reparation of the bankrupt estate, those arising from judicial or extra-judicial procedures for the benefit of the bankrupt estate, the fees and expenses of the trustee (provided that those expenses were strictly necessary for the performance of their duties, and provided that they were duly proved); and
- (b) tax duties which will be paid after the uniquely privileged creditors and secured creditors.

If the creditors do not receive the entire amount of their debts once the bankruptcy estate has been distributed, they have the right to pursue the debtor independently for the balance.

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

Mexican tax implications vary depending on the structure of the entity used for investment. Investments made within Mexico, including buyouts, may benefit from Mexico's wide range of double tax treaties with other countries. As mentioned in the answer to question 6, when structuring LBOs in Mexico, it is important that acquisition financing is injected at the operating target company level for tax reasons (often there is a post-acquisition restructuring of the debt component).

### Transfer tax/stamp duty

There is no stamp tax in Mexico. As such, there is no transfer or other duty on the transfer of shares.

### Deductibility and financing costs

As a general rule, interest paid by a resident of Mexico is deductible from the company's taxable income. However, Mexican thin capitalization rules may limit the deductibility of interest paid to foreign related parties (see below).

Interest payments to a Mexican bank would be deductible in Mexico, unless they are derived from a back-to-back loan<sup>25</sup>.

<sup>25</sup> In general terms a back-to-back loan exists under article 11 of the Mexican Income Tax Law, in the following cases:

- (a) a transaction by which a company gives or renders cash, goods or services to another company, who gives or renders, directly or indirectly, cash, goods or services to the first company or a related party of the first company; and
- (b) a bank grants financing to the company and that loan is guaranteed by a related party of the company with cash deposits, shares, and debt instruments.

## Thin capitalization

In essence, the thin capitalization rules in Mexico disallow the deduction of interest related to debt owed to non-resident related parties, if the total amount of all debt-generating interest exceeds three times the taxpayer's book equity. These rules, however, do not apply to entities that are considered to be part of the financial system (i.e., banks and other entities), provided that the debt has been entered into so that those entities can carry out their business activities.

Taxpayers could obtain a favorable ruling from the tax authorities to increase the equity limitation if they can demonstrate that their transactions with related parties are at arm's length by having proper supporting transfer pricing documentation.

## Withholding tax

Interest payments to non-residents are subject to withholding tax at varying rates, depending on the type of entity making or receiving the interest payment. The withholding rates set out in the Income Tax Law range from 4.9% to 35%.

Interest payments are generally subject to a 35% rate withholding tax, unless they fall into one of the following categories:

- (a) If the recipient is a foreign bank or other financial institution that is the beneficial owner of the interest and provides certain information requested by the Tax Administration Service, interest payments are subject to withholding tax at the rate of 10%, which may be reduced to 4.9% if certain requirements are met.<sup>26</sup>
- (b) A 4.9% rate is available to certain interest paid to non-residents derived from certain securities traded in stock exchange markets if certain requirements<sup>27</sup> are met or the tax will be determined at a 10% rate.
- (c) Interest paid to reinsurance companies is subject to withholding at a 15% rate.
- (d) interest payments are subject to withholding at the rate of 21% in the following cases:
  - (i) the entity making the payment is a financial institution and the recipient is an entity other than a bank or financial institution; or
  - (ii) the recipient of the interest is either:
    - (A) a foreign supplier of machinery and equipment that is part of the taxpayer's fixed assets; or
    - (B) a foreign entity that finances the purchase of that machinery and equipment, or provides working capital financing under an agreement that sets out these circumstances.

Notwithstanding the rates set out in the Mexican Income Tax Law, tax treaties could provide benefits by way of lower withholding rates, for example, under the Mexico-U.S. Tax Treaty, the applicable rates could be 4.9%, 10%, or 15% depending on the type of recipient of interest payment.

## Taxation on dividends

After-tax dividend distributions to domestic corporate shareholders are not taxed.

---

<sup>26</sup> Several formal requisites must be fulfilled, among others, file notices with tax authorities, gather supporting documentation in order to evidence that recipient of interest payment qualifies, as may be applicable, as government bank, financial institutions, reinsurance companies and the other type of recipients described above.

<sup>27</sup> *Idem*



However, dividend payments made to shareholders that are non-residents in Mexico for tax purposes, are subject to a withholding tax at a rate of 10%. (Tax treaties may provide for a lower withholding rate.)

Mexican entities must keep a 'net after tax profit account' (*cuenta de utilidad fiscal neta*) (CUFIN). When a dividend distribution is not made from the CUFIN, the Mexican company making the distribution (and not the recipient) is subject to a 30% tax on the gross profit distribution (at the corporate level). This tax can be credited against the company's year-end income tax for that year and for the following two years.

### Capital gains tax - immovable property

For companies that are Mexican tax residents, capital gains realized from the transfer of land are subject to regular corporate income tax on a net income basis at the corporate tax rate of 30%. From a broad perspective, the taxable profit is obtained by subtracting the original cost of the acquisition (adjusted for inflation) from the sales price.

Capital gains realized by non-residents from the transfer of immovable property are subject to a 25% withholding tax on the gross amount. Non-residents having appointed representatives in Mexico or concluding the transfer through a public deed may in certain cases elect to pay 35% on the net gains.

The specific requirements are among others:

- (a) the appointment of a legal representative for tax purposes in Mexico;
- (b) the transferor must not reside in a country where income derived is subject to a preferential tax regime or a territorial tax regime; and
- (c) the filing of a tax opinion with tax authorities (*dictamen fiscal*) prepared by a public accountant duly certified and registered before the Mexican Treasury.

For capital gains obtained by non-residents, the tax administration may appraise the value of transferred property and if the appraisal exceeds 10% of the amount declared by the parties, the excess amount will be subject to a 25% tax payable by the non-resident acquirer.

### Capital gain tax - shares

Capital gains realized by non-residents from the disposal of shares and other securities issued by a Mexican resident, or those shares whose value is directly or indirectly represented in more than 50% by real estate property located in Mexico, are subject to a 25% withholding tax on the gross amount received. Non-residents having an authorized representative in Mexico may elect to pay 35% on the net gain calculated under specific rules, if not a resident of a Preferential Tax Regime (PTR) or a resident of a country where income tax is based on the territoriality principle.

In certain corporate reorganizations, private rulings can be sought to defer the payment of income tax.

## 21. What forms of exit are available?

The most common forms of exit in a solvent situation may include a trade sale, typically in the form of a sale of shares or an asset sale. Occasionally there may be some domestic, foreign or combined form of an IPO.

The most common form of exit in an insolvent situation is the trade sale of the assets of the company. Under certain circumstances, some lenders may also be willing to convert their loans into equity and take control of both the financing and the operating of the company under financial stress for a limited time to improve its financial profile for a later structured exit.

## The Netherlands

### 1. What structures do private equity funds typically use to manage their funds?

#### Common structures

Two structures are commonly used by private equity funds to manage Dutch funds raised from their investor base (the private limited company and limited partnership as described in further detail below). It is not uncommon for many of the larger Dutch private equity funds with foreign investors to have both structures available within the one overall fund structure. The investors would be either shareholders of the BV, or limited partners of the CV, depending on their particular tax situation.

##### *Private limited liability company*

A private limited liability company (*besloten vennootschap met beperkte aansprakelijkheid*) (**BV**) structure is regularly used. A BV is an entity with legal personality, with capital divided into shares that can be issued in separate classes attaching different rights. For instance, shares can have certain enhanced voting rights, enhanced rights to dividends, no voting rights, no rights to dividend or rights to a carried interest.

It is not uncommon for the management shares to be issued to a special purpose management vehicle that is owned by individual fund managers, either directly or indirectly through a personal holding company.

##### *Limited partnership*

A limited partnership (*commanditaire vennootschap*) (**CV**) structure is also regularly used. A CV is a creature of contract rather than an entity with legal personality. A CV issues no shares, but the partnership interests can attach different rights.

Normally the investors are limited partners with the same rights and obligations attaching to their interest. The fund manager is a general partner that takes day-to-day management control of the partnership and its operations. The fund manager may have special rights under the partnership agreement, including a right to receive a fixed fee and a carried interest.

The general partner may be a BV vehicle owned by the individual fund managers, either directly or indirectly through a personal holding company.

#### Alternative structures

There are alternatives to the BV and CV structures. They are set out below.

##### *A fund for joint account*

A fund for joint account (*fonds voor gemene rekening*) is a mix of legal entities and contracts usually consisting of separate entities (e.g., BVs) acting as custodian and manager of the fund. The investors subscribe for units, governed by general terms and conditions, and enter into a separate management agreement or a separate custody agreement.

Historically, this type of fund is used for larger groups of investors and is more common to traditional investment funds or hedge funds.

##### *Co-operative*

A co-operative (*coöperatie*) is a legal entity with a very high degree of flexibility in relation to equity and debt financing, as well as voting and governance arrangements.



## 2. Do funds need to be licensed by any regulatory authority to conduct business in the Netherlands?

A private equity fund that requests or obtains monies (or other goods) for collective investment purposes, whether by issuing securities or participation rights to persons or entities providing those monies (or other goods) for those persons or entities to share in the proceeds of the investments made by the fund, qualifies as an alternative investment fund (*beleggingsinstelling*) under the Dutch Financial Supervision Act (*Wet op het financieel toezicht*). This is irrespective of whether the alternative investment fund is an entity with separate legal personality (an investment company; *beleggingsmaatschappij*), or just a contractual arrangement personality, for example a CV or a fund for joint account (an investment fund; *beleggingsfonds*).

In principle, for the (manager of the) alternative investment to lawfully offer the fund's securities or participation rights in the Netherlands, a licensing requirement is applicable to the investment manager of the fund. The license must be obtained from the Netherlands Authority for the Financial Markets (*Stichting Autoriteit Financiële Markten*) (**AFM**). To obtain the required license, the (investment manager of the) fund must comply with extensive organizational, information and conduct-of-business requirements as set out in the relevant legislation, which include, among other things:

- (a) the obligation to provide the Dutch Central Bank (*De Nederlandsche Bank*) and the AFM with information in relation to the manner in which it manages the funds, which funds it manages, the investments of the funds and the markets on which the funds will be active;
- (b) the obligation to provide prospective investors with a prospectus (whether or not approved by the AFM) of any alternative investment fund managed by it;
- (c) the obligation to provide investors in the fund with certain information;
- (d) the obligation to, within six months after the end of its financial year, provide the AFM with the annual report of the fund (or within four months if it is a close-ended fund whose units or shares have been admitted to trading on a regulated market);
- (e) notification requirements in relation to the acquisition of major holdings and control of both listed and non-listed companies that have issued securities (*effecten*) or that intend to issue securities (*uitgevend instellingen*) and the information requirements related to them to the AFM, to the company itself and to the shareholders of the company; and
- (f) compliance with the asset stripping prohibition rules (i.e., if a fund managed acquires control over a non-listed company, it may not cause, among other things, any distribution, capital reduction, share redemption and/or acquisition by the company of shares owned by the fund in it during a period of two years).

In general, exemptions from having to obtain prior prospectus approval from the AFM apply if:

- (a) the securities are solely offered to qualifying investors;
- (b) the securities are offered to fewer than 150 persons, other than qualifying investors;
- (c) the securities offered may only be acquired at a consideration of at least EUR 100,000 per investor;
- (d) the nominal value per security is at least EUR 100,000;
- (e) the total consideration of the offer of securities to the public in the European Economic Area (*Europese Economische Ruimte*) is less than EUR 100,000 (and that limit is calculated over a period of twelve months); or

- (f) the alternative investment fund whose units or shares are offered is an open-ended fund (i.e., the units or shares in the alternative investment fund are, at the request of any of its shareholders or unitholders, re-purchased or redeemed prior to the commencement of its liquidation phase, or wind-down, directly or indirectly, out of the assets of the alternative investment fund and in accordance with the procedures and frequency set out in the rules or instruments of incorporation or offering documents of the alternative investment fund).

### 3. Are there any approvals required for investments by foreigners in the Netherlands and, if so, what is the process?

#### Foreign investment restrictions

Acquisitions of Dutch companies or businesses by foreigners are not subject to government approval or review, with the exception of acquisitions in certain regulated sectors (banks, insurance companies and broadcasting corporations). Foreign investors are, in principle, allowed to invest in defense, aviation, media and telecommunications (although currently there are discussions regarding the need for a declaration of no objection that must be obtained prior to acquiring a substantial holding in a telecommunication company).

#### Qualified holdings in financial institutions

If an investor obtains or increases a 'qualified holding' (i.e., 10% or more of the issued share capital, or the ability to cast 10% or more of the votes at a general meeting) in certain financial institutions such as for example licensed banks, insurers and investment firms that have their statutory seat in the Netherlands, a statement of no-objection must be obtained from either the Dutch Central Bank or the AFM. It is prohibited to acquire a qualified holding without having obtained a statement of no-objection. Breach of this prohibition can be sanctioned by the Dutch Central Bank or the AFM among others by imposing an order, subject to a penalty for non-compliance or by imposing an administrative fine. Finally these breaches can be criminally sanctioned by imposing prison sentences or penalty fines.

#### Exchange controls

There are no exchange controls prohibiting or restricting payments to and from the Netherlands. Consequently, the transfer or repatriation of profits and capital gains to and from the Netherlands is entirely free.

### 4. Who are the relevant regulators in the Netherlands and how much interaction would one generally expect when undertaking a buyout?

The primary regulatory authorities in The Netherlands in a corporate context are:

- (a) the Netherlands Authority for the Financial Markets (*Stichting Autoriteit Financiële Markten*) (**AFM**) – the primary regulator of corporate and financial services laws;
- (b) Euronext Amsterdam N.V. (**Euronext**) – the Dutch part of the Euronext stock exchange that provides additional regulation for listed entities;
- (c) the Consumer and Market Authority (*Autoriteit Consument and Markt*) (**ACM**) – the telecommunication and competition/antitrust regulator;
- (d) the Social and Economic council of the Netherlands (*Sociaal-Economische Raad*) – if certain thresholds are met in relation to the number of employees involved, companies must report a proposed takeover/merger to the Secretary of the Social and Economic Counsel pursuant to the Merger Code 2000 (*Fusiegedragsregels 2000*);



- (e) the Dutch Central Bank (*De Nederlandsche Bank*) – the regulator for the financial services industry; and
- (f) the Taxation Authority - if preferred, certainty in advance regarding the taxation the transaction can be obtained from the Dutch tax authorities.

The level of expected involvement with AFM and Euronext in a buyout situation largely depends on whether or not the transaction is being undertaken in relation to a publicly listed company. Interaction with the other authorities depends on the nature of the transaction (e.g., if it is a buyout in the media sector and if it involves competition/antitrust issue) and the parties concerned.

## 5. How are buyouts typically undertaken in the private and the public markets?

### Private context

In a private context, transactions are usually undertaken by way of negotiated acquisition. That is, sale and purchase documents are prepared, negotiated and executed and those documents record the terms of the sale and acquisition and the rights and liabilities of the parties.

Frequently, the buyout takes place following an ‘auction’ process where several competing bidders are invited by the seller to bid for the target company and where the seller ordinarily concludes a sale and purchase agreement with the bidder that offers the highest price and the most favorable contractual terms. The competitive tension generated by a well-run auction process permits a seller to maximize the price obtained and reduce its exposure by minimizing the number of warranties and indemnities given by the seller to the buyer in relation to the target business.

### Public context

#### *General*

Public buyouts are generally concluded by way of a friendly, hostile or mandatory public takeover offer. A public takeover, or an offer in relation to the issued and outstanding securities of a public company, whose securities are admitted to trading on a regulated market in the Netherlands, is subject to the statutory rules set out in the Act on Financial Supervision (AFS) and its subordinate regulations.

#### *Friendly offer*

In the case of a friendly offer, there is an agreement between the bidder and the management board of the target company in relation to the terms of the proposed offer. The management board of the target company would announce its support for the offer.

#### *Hostile offer*

A hostile offer is an offer that is not based on an agreement with, nor supported by, the management board of the target company. In this case, it is not uncommon for the target company to activate any anti-takeover measures it has in place.

#### *Mandatory offer*

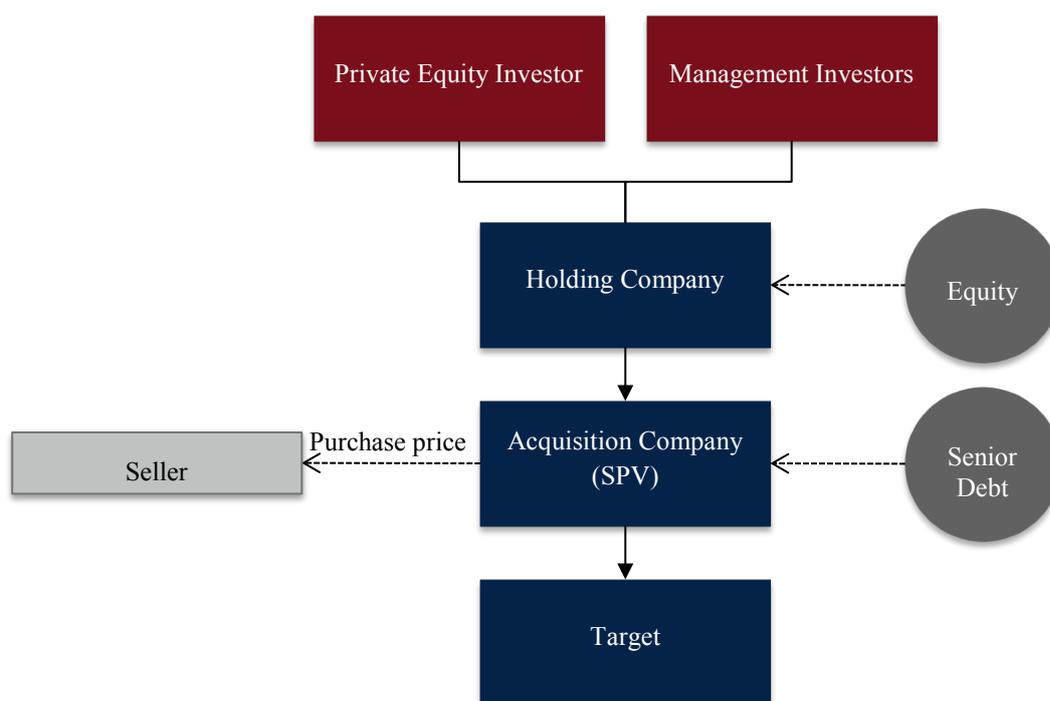
A mandatory offer in relation to a public listed company must be made by the person or entity that acquires ‘predominant control’ of that company. ‘Predominant control’ is deemed to occur when the acquiring person or entity is able to exercise 30% or more of the voting rights in the general meeting of shareholders of the public listed company. The obligation to launch a public takeover offer also applies to persons or entities that acquire predominant control while acting in concert, together with other persons or entities.

## Offer document

Under the AFS, it is prohibited to make a public takeover offer for securities of a public listed company, unless an offer document has been made publically available by the bidder before launching the offer. This offer document must meet certain specific criteria and must be approved by the AFM or by the competent supervisory authority of another EEA country prior to its publication. The AFM (or, if applicable, the competent supervisory authority of another EEA country) assesses whether the offer document contains all information that is required for a reasonably informed person to form a well-considered opinion on the offer. It usually takes one or two months for the AFM to approve an offer document.

## 6. What is the typical corporate structure used when doing a buyout?

Although acquisition structures do vary from transaction to transaction, it is fairly common to see a two level holding company structure adopted along the following lines:



This structure allows for the senior debt finance to be provided to the Acquisition Company SPV, while the equity contribution from the private equity fund or funds is contributed at the holding company level and subsequently contributed down to the Acquisition Company SPV in the form of unsecured loan funds or equity.

More elaborate structures invariably exist on larger more complex deals, particularly where any debt funding involves mezzanine funding sources that may need to be structurally subordinated to the senior financiers but rank ahead of any equity contributed by the private equity fund(s).



## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

#### *Private context*

For a buyout negotiated in a private context the primary legal document that records the transaction is invariably the sale and purchase agreement. There may also be other ancillary transaction documents prepared depending on the nature of the deal. These can include the following:

- (a) letter of intent;
- (b) confidentiality agreement
- (c) shareholders agreement and articles of association;
- (d) management agreements; and
- (e) transition/shared services agreement.

#### *Public context*

For a buyout in a public context the documentation also includes:

- (a) a fairness opinion (note that this is not strictly required under Dutch law but is market practice);
- (b) for a 'friendly bid', a bidder's offer document and a 'merger protocol' is also required:
  - (i) the offer document sets out the offer made to the existing shareholders, including certain prescribed disclosures, together with the range of terms of the offer by the bidder and may be supplemented through the course of the bid period; and
  - (ii) the merger protocol is the primary document negotiated between the bidder and the target, and is an 'implementation agreement'. This records the agreement of the parties to implement the acquisition and the terms on which they have agreed to do so (including any conditionality);
- (c) all documents in connection with convening an extraordinary general meeting of shareholders of the public target company.

### Banking

The main banking document is the senior facilities agreement under which the senior debt facilities (typically amortizing and non-amortizing term loans with working capital lines and, in some instances, capital expenditure or acquisition facilities) are documented.

If there is subordinated or mezzanine debt, there is typically a separate facility agreement under which that debt is made available and an intercreditor or subordination deed recording the respective rights of the senior and subordinated/mezzanine lenders.

Security may be held by a security trustee for the lenders on the basis of separate security documentation. The security is typically a fixed charge.

Hedging is virtually always documented in an ISDA multi-currency master agreement.

## 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

### Private context

In a private context, buyer protection usually takes the form of negotiated warranty and indemnity coverage from the seller (being either the shareholder(s) in a share sale, or the company from which the business and assets are being acquired). The terms of that coverage varies from transaction to transaction. However, it is quite normal to expect that limits be placed on that coverage, including claim thresholds and caps, time limits and adjustments for items otherwise disclosed or accounted for.

More frequently buyers seek warranty & indemnity insurance or place a portion of the sale proceeds in escrow for a period. Over the last few years there has been a significant increase in insured deals from the Netherlands, both on the sales of private equity Dutch based holding companies (with the underlying business functioning elsewhere in Europe) and on the sales of Dutch companies/assets.

As the warranty & indemnity insurance deal tool has become more widespread, Dutch buyers and sellers are more comfortable with the idea of structuring a deal in this way. The typical W&I insurance terms for mid-market European deals are as follows:

- (a) policy limits for private equity deals are generally 10-50% of the deal value; and
- (b) premium rates for private equity deals are typically 1.2-1.8% of the policy limit with 1% retention.

### Public context

In a public context, the level of buyer protection which can be obtained is less than in a private context. The main form of protection usually takes the form of conditions precedent to the acquisition (that either need to be satisfied or not triggered).

## 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

There are no specific laws regulating how conflicts are managed in a management buyout. The Dutch Civil Code (*Nederlands Burgerlijk Wetboek*) does, however, provide general rules in relation to how to manage conflicts of interest of the management board or its individual members.

It is not unusual for management (and sometimes the private equity fund) to execute a management protocol setting out certain agreed protocols for how the information flow and other key interactions during the buyout are to be managed so as not to disadvantage the seller or the target company.

## 10. How are the equity arrangements typically regulated in a buyout?

The equity arrangements in a typical buyout are regulated primarily by a shareholders agreement and the articles of association of the holding company.

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

There is a great deal of flexibility under Dutch law in relation to the types of equity security that can be issued and the level of 'rights tailoring' that can occur. It is common to see different classes of security issued to management and the private equity fund in a buyout, with a variety of different rights. Equity interests may take the form of:

- (a) ordinary shares;



- (b) preference shares;
- (c) priority shares;
- (d) non-voting shares;
- (e) shares without profit rights;
- (f) redeemable and convertible shares;
- (g) warrants; and
- (h) convertible (subordinated) loans.

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

Dutch law distinguishes between two types of limited liability company:

- (a) public companies (*naamloze vennootschap/NV*); and
- (b) private limited liability companies (*besloten vennootschap/BV*).

### One-tier board and two-tier board structures

The board of a Dutch company can either be organized as a ‘one-tier board’ (resembling the Anglo-Saxon board composition with executive- and non-executive board members united in one board) (**One-Tier Board**), or a ‘two-tier board’ structure where non-executive and executive members are divided into two different boards (the management board and supervisory board, respectively) (**Two-Tier Board**). The Two-Tier Board structure is still the most common structure in the Netherlands.

In a Two-Tier Board structure, the members of the management board are responsible for the general course of affairs by which the members of the supervisory board can advise and must supervise the managing directors. Supervisory board directors are not allowed to participate in management affairs. An obligation to have a two-tier system exists if the BV or NV falls under the so-called ‘large companies regime’ (**LCR**). The LCR will apply to a company if, for three consecutive years, it meets all of the following criteria:

- (a) it has an issued share capital plus retained earnings and reserves of at least EUR 16 million;
- (b) it has a works council (or an interest of 50%+ in a dependent company which has a works council); or
- (c) the company, together with its subsidiaries, normally employs at least 100 employees in the Netherlands.

Dutch company law recognizes total and partial exemptions from the LCR. Companies which are fully exempt include group holding and finance companies, as long as the majority of the employees of the group work outside the Netherlands. A partial exemption (called the ‘mitigated large companies regime’) applies to a large company in which one or more other companies have an interest of 50% or more, as long as the majority of the employees of the companies work outside the Netherlands.

The board of supervisory directors must supervise the policies of the board of managing directors and general affairs within the company and its business. It must give advice to the board of managing directors, but may not in principle participate in the management of the company other than by offering general policy guidance.

The term ‘One-Tier Board’ implies the presence of non-executive board members. The general course of affairs is the responsibility of the board of directors as a whole (both the executives and the non-executives), therefore resulting in a more timely and direct involvement of the non-executives. The executives are charged with the day-to-day business of the company.

### Board constituency and differential voting rights

The management of the BV and the NV is vested in the board of managing directors, consisting of one or more managing directors. The articles of association may provide for a minimum number of managing directors. Dutch company law does not require the managing directors to be Dutch residents. Managing directors can be legal entities.

Members of supervisory boards or non-executive directors must always be private individuals.

Generally, issues regarding the boards’ constituency, differential director voting rights and the removal of directors are all governed in the shareholders agreement and the articles of association. It is common for private equity funds to have specific appointment and removal rights in relation to a certain number of supervisory directors (or non-executives) of their portfolio companies, or the management board of the holding company.

### 13. What measures are commonly used to give a private equity fund some level of control over key operating and financial decisions made by a portfolio company?

Control over key operating and financial decisions made by a portfolio company is generally obtained via the shareholders agreement and the articles of association and is commonplace. It is secured by the private equity fund having, under the shareholders agreement:

- (a) the right to appoint one or more members to the management board or the supervisory board of the portfolio company;
- (b) rights to receive financial and operating information on a regular basis; and
- (c) specific consent or veto rights over particular decisions of the portfolio company, including decisions that relate to operating or financial matters.

### 14. What employment terms are generally imposed on management in a buyout?

It is common for senior members of a management team in a buyout to enter into an executive services or management agreement, generally for a fixed period of time. It is important to ensure that the terms and conditions do not qualify as an ‘employment condition’ which would result in the imposition of mandatory Dutch employment laws applicable to the termination of the executive services/management agreements, as well as (wage) tax and social security premiums becoming due (with retroactive effect). Specific advice should be sought as the way the agreement is worded (including the title of the agreement) as this may have unintended legal consequences.

For remuneration under these agreements it is common to include a fixed component (a ‘management fee’) and a variable component referring to performance (either of the executive or the company).

Equity incentives offered to management may be covered in the shareholders agreement, the executive services/management agreement or a specific incentive plan.

Restrictive covenants are usually included in the shareholders agreement as well as in the executive services/management agreement.



## 15. What equity incentives can be offered to management and how are they typically structured?

There is a great deal of flexibility in relation to incentives offered to management.

These incentives generally take the form of ordinary equity or options over ordinary equity, either held by management directly or in options over depository receipts for shares through a trust foundation (*stichting administratiekantoor*).

It is not uncommon for equity plans to be adopted to regulate the way in which management equity is issued (which can include an earning or vesting of the equity over a period, subject to achievement of agreed financial hurdles) and which can be reacquired by the portfolio company or acquired by the private equity fund if a manager ceases to be employed for any reason.

‘Good leaver’ and ‘bad leaver’ provisions are very common (either in the shareholders agreement or the relevant plan terms) and effectively give the portfolio company itself (or its remaining shareholders) the right to acquire the equity at a pre-determined price in a leaver situation.

## 16. How are buyouts typically debt financed and secured?

### Lending

While it varies from transaction to transaction, typically between 60% and 70% of the cost of an acquisition is provided from debt lent by banks and financial institutions. The amount of debt that can be raised is typically calculated as a multiple of the earnings of the target business.

### Security

The debt finance provided may take various forms and typically includes senior term loans, working capital facilities and mezzanine loans, both in the form of bank debt and shareholder loans. The priority between the various (debt) finance components is established in an intercreditor agreement

Security is typically by way of a share pledge over the shares in the target company and by way of (depending on the specific type of asset) pledges and mortgages over the assets of the target company. The target companies also cross-guarantee their obligations to the bank lenders.

## 17. Are there financial assistance issues to consider when undertaking a buyout?

### Prohibition against giving financial assistance

A distinction must be made between the acquisition of shares held in the capital of a Dutch public company with limited liability (**NV**) and the acquisition of shares held in the capital of a private company with limited liability (**BV**).

Currently, under Dutch law, the financial assistance prohibition is only applicable when dealing with NVs. By legislative changes in Dutch company law effective from 1 October 2012, the prohibition on financial assistance in connection with the acquisition of shares held in the capital of a BV has been abolished.

Under Article 98c of Book 2 of the Dutch Civil Code (*Burgerlijk Wetboek*) (**DCC**), an NV may not provide security (collateral), give a share price guarantee, vouch for third parties in any other way or make itself jointly and severally liable for a third party’s debt in addition to, or instead of, that third person or otherwise, with a view to the subscription, payment of or acquisition of any of the shares in the NV (or depository receipts issued for those shares), or to refinance any indebtedness incurred for the subscription or acquisition of its shares by others. This prohibition also applies to an NV’s subsidiaries, both domestic and foreign.

## Financial assistance in the form of a loan

Under the financial assistance prohibition, an NV and its subsidiaries are also prohibited from granting loans for the purpose of a subscription for, or the acquisition of, its own shares (or depository receipts for those shares) by others, unless the board of managing directors of the NV has resolved to do so and the following requirements are met:

- (a) the granting of the loan, including the interest received by the NV and the securities provided to the NV, are made under fair conditions;
- (b) the NV's equity (total assets minus liabilities) according to the last adopted balance sheet, reduced by the amount of the granted loan, is not less than the paid up and called up share capital plus the reserves which must be maintained by law or the articles of association if the NV's annual accounts have not been adopted more than six months prior to the granting of the loan;
- (c) the creditworthiness (solvency) of the third party or, if it concerns an agreement between more than two parties, of each involved party, has been carefully examined;
- (d) if the loan is granted for the purpose of a subscription for shares in connection with an increase of the issued share capital of the NV or for the purpose of obtaining shares in the NV's capital that are held by the NV itself, the price for which the shares are taken or acquired must be fair.

When granting a loan in accordance with the requirements set out above, an NV must maintain a non-distributable reserve equal to the amount of the granted loans.

A resolution of the board of managing directors to grant a loan as referred to above, is subject to the prior approval of the NV's general meeting of shareholders. If shareholders with less than 50% of the issued share capital are represented at the meeting, a resolution of the general meeting approving the loan must be taken by a majority of at least two-thirds of the votes cast.

For an NV whose shares are admitted to trade on a regulated market or a multilateral trading facility as defined in Article 1:1 of the Dutch Financial Supervision Act (*Wet op het financieel toezicht*) (FSA), the resolution must be passed by a majority of at least 95% of the votes cast. When the approval is requested of the general meeting, this is reported in the convening notice for that general meeting. Together with the convening notice, a report is deposited at the trade register office of the chamber of commerce for inspection by the shareholders and the holders of depository receipts with meeting rights. That report must set out the reasons for granting the loan, the interest in that transaction for the NV, the terms and conditions on which the loan is to be granted, the price for which the shares are to be taken or acquired by the third party and the risks connected to the loan in relation to the liquidity and solvency of the NV

## Exceptions

The financial assistance rules laid down in Article 98c of Book 2 of the DCC do not apply to:

- (a) transactions where shares or depository receipts for shares are taken or acquired by or for employees of the NV or employees of a group company; or
- (b) a licensed bank.

## Contravening acts void

It is generally considered by legal scholars in the Netherlands, that any legal act that contravenes the rules on financial assistance is considered void.



## 18. What are the implications under the corporate benefit laws of the Netherlands for a company providing financial assistance?

If an NV or BV (or its subsidiaries) intends to provide financial assistance (in the form of a loan as discussed above or by granting security), the relevant Dutch company must ensure that:

- (a) it derives a corporate benefit from the obligation for which the financial assistance is provided; and
- (b) the company's existence is not threatened by the provision of the financial assistance.

In general, a company is deemed to benefit from the provision of financial assistance if a strong financial and commercial interdependence exists between the company and the other (future) group members for which financial assistance is given and the company's existence is not expected to be endangered by providing the financial assistance. In other words, a hypothetical assessment must be made about the company's financial and commercial position as if financial assistance were given. If and to the extent there appears to be an imbalance between the commercial benefit gained by the company and the detriment it would suffer if the financial assistance was called on, the company (or the trustee in bankruptcy) is able to contest the validity of the financial assistance under the corporate benefit rules.

This is the case irrespective of the wording of the objects clause in the articles of association of the NV (or relevant subsidiary), although the objects clause is an indication of the possibility of granting loans or security for the benefit of others rather than for the benefit of the company itself.

There is no unanimous view in Dutch legal doctrine, however, in relation to the benefit required. Therefore, it cannot be ruled out that (following the hypothetical assessment), even if there is a strong financial and commercial interdependence, a transaction might be declared void by the Dutch courts if it is evident that the transaction cannot serve the realization of the company's objects. In light of the above, it is advisable to include wording in the recitals of the financial assistance agreements that explicitly refers to the economic and commercial benefits for the company in entering into the relevant agreement, as well as to reflect this in the corporate authorizations of the companies entering into the financial assistance agreements.

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

In any external administration, bankruptcy (*faillissement*) or suspension of payments (*surséance van betaling*), of a company:

- (a) the secured creditors rank ahead of the unsecured creditors;
- (b) the unsecured creditors rank ahead of the subordinated creditors; and
- (c) the subordinated creditors rank ahead of the shareholders.

However, certain unsecured creditors may rank ahead of the holder of a pledge or a mortgage, such as:

- (a) creditors with retention rights;
- (b) debtors of pledged receivables who are also creditors of the borrower under the same legal relationship; and
- (c) the tax authorities in respect of certain tax claims on the proceeds of certain movable assets.

During a bankruptcy the courts may also temporarily freeze the enforcement by secured lenders of their security.

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

There are three main tax aspects to consider when undertaking a buy-out in the Netherlands, namely:

- (a) taxation of capital gains on exit;
- (b) taxation of dividend distributions; and
- (c) deduction of the interest expense incurred by the Dutch acquisition vehicle or, in the case of a debt push down, the Dutch target.

They are discussed in more detail below.

### Stamp duty/transfer taxes

The Dutch tax system does not contain stamp duties or similar documentary taxes or charges. As such, the acquisition/transfer of shares in a Dutch company is not subject to stamp duties (or other similar taxes/charge relating to documents/registration of/formalities to do with documents).

However, the acquisition of a minimum of one-third of the outstanding shares (or a similar financial interest) in a company owning real estate may trigger the levy of Dutch real estate transfer tax (the statutory rate is 6%). This generally happens if the following two conditions are met at the level of the company in which the shares are transferred:

- (a) the assets of the company consist (or have consisted in the preceding year) of at least:
  - (i) 50% real estate (including rights that qualify as real estate (e.g., economic ownership, financial lease), and
  - (ii) 30% real estate within the Netherlands; and
- (b) the purpose of the company is the exploitation of real estate owned by the company (i.e., at least 70% of the real estate owned should be destined for sale or rental).

Some specific transfer tax exemptions apply (e.g., a transfer tax exemption could apply within the context of an internal reorganization).

### Taxation of capital gains on exit

#### *Dutch resident entity*

Generally capital gains are subject to Dutch corporate income tax at a rate of 25%<sup>28</sup>. If, however, an entity has a shareholding of at least 5% of the nominal paid-in capital in the target company, the capital gain realized is not taxed, if the Dutch participation exemption regime applies (see below).

#### *Non-resident entity*

If the non-resident entity is resident in a country that has concluded a tax treaty with the Netherlands that allocates the right to tax capital gains on shares exclusively to the country of the seller, the Netherlands does not tax the capital gain. Almost all of the Dutch tax treaties allocate the right to tax capital gains realized on the sale of Dutch shares exclusively to the country of the seller.

---

<sup>28</sup> Profits up to EUR 200,000 are taxed at a Dutch corporate income tax rate of 20%



If the entity selling the Dutch shares is resident in a country that has not concluded a tax treaty with the Netherlands, or the tax treaty does not contain sufficient protection against the taxation of the capital gain, a distinction is made between sellers that own less than 5% of the nominal paid in capital of the Dutch target and sellers that own at least 5% of the nominal paid in capital in the Dutch target. If the shareholding is less than 5%, then the Netherlands does not tax the capital gain. If the shareholding is 5% or more, the entity may be taxed on the capital gain (current rate: 25%) unless:

- (a) the seller owns the shares in the Dutch target as part of its business enterprise; or
- (b) the avoidance of Dutch personal income tax or Dutch dividend withholding tax is not (one of) the main purpose(s) to hold the shares in the Dutch target through the non-resident entity.

The first exception generally applies if, before the sale, the seller has had a direct influence on the management of the Dutch target company (e.g., because it had appointed its own representative(s) onto the board of the Dutch target company).

The second exception applies if the non-resident entity has a real function in the holding structure and it can therefore not be seen as an artificial arrangement. A non-resident private equity fund is generally not taxed on capital gains in the Netherlands if it is actively involved in the management of the Dutch target. In that case, it is generally possible to obtain an advance tax ruling from the Dutch tax authorities confirming that the non-resident entity will not be subject to Dutch corporate income tax.

## Taxation of dividends

### *Distributions*

Dividends distributed by a Dutch target are subject to 15% Dutch dividend withholding tax, unless that rate is reduced on the basis of an exemption under Dutch tax law or on the basis of the application of a tax treaty concluded between the Netherlands and the country of the recipient of the dividend.

Dividends distributed by a Dutch target to a Dutch recipient are not subject to Dutch dividend withholding tax, if the recipient is an entity subject to Dutch corporate income tax and the participation exemption applies. This is the case if the recipient owns at least 5% of nominal paid-in capital of the Dutch company distributing the dividend. Under the participation exemption regime, the recipient is not taxed on the dividends received.

### *Distributions to EEA residents*

Dividend distributions made to recipients resident within the European Economic Area (which includes the European Union) (EEA) and that qualify for the Parent Subsidiary Directive, are exempt from Dutch dividend withholding tax. The Netherlands applies this exemption if the shareholder owns at least 5% of the nominal paid-in capital of the Dutch company paying the dividend and the recipient is the beneficial owner of the dividend.

### *Distributions made by a Dutch cooperative*

Unlike profit distributions by a BV or NV, profit distributions made by a Dutch cooperative are generally not subject to Dutch dividend withholding tax. However, if one of the main purposes to interpose a cooperative between the non-resident investor and the target is to avoid Dutch dividend withholding tax or foreign taxation, and the membership right in the cooperative is not part of the business enterprise carried out by the member, profit distributions to that member are subject to Dutch dividend withholding tax (unless an exemption applies on basis of a tax treaty).

Profit distributions by a Dutch cooperative to a non-resident private equity fund are generally not subject to Dutch dividend withholding tax if it is actively involved in the management of the target. In that case it is generally possible to obtain an advance tax ruling from the Dutch tax authorities

confirming that profit distributions to the non-resident entity will not be subject to Dutch dividend withholding tax.

## Deductibility of interest and financing costs

The interest expense due on acquisition debt is generally tax-deductible in the Netherlands. The Netherlands does not have thin capitalization rules (they were abolished in 2013). However, deductibility of interest can be limited on the basis of specific anti-abuse rules. Three specific anti-abuse rules are discussed below.

### *'Anti base erosion' rule*

The first rule is the 'anti base erosion' rule which combats the 'artificial' creation of related party debt that results in the reduction of the Dutch taxable income. These rules also apply to typical debt structures such as the merger of the Acquisition Company (which owes the debt) with the target company when the target company has taxable profits from operating activities.

Other types of transactions that are affected by the anti-base erosion rules are, for instance, leverage recapitalizations or leveraged dividend distributions where after a buyout the target would borrow from a related party to either repay capital or distribute a dividend. That interest expense would not be deductible.

### *Acquisition or extension of equity investments in participations that qualify for the participation exemption*

The second rule that may limit the deduction of interest is connected with the acquisition or extension of equity investments in participations that qualify for the participation exemption. If and to the extent the cost price of the participation exceeds the fiscal equity of the Acquisition Company, the excess part is deemed to be financed out of debt. The interest attributable to the excess debt is not deductible, except for the first EUR 750,000. The cost price of the participation is however reduced to the extent the business of the group is extended, unless there is a double interest dip or hybrid financing structure put in place.

This rule applies to monies borrowed from both related and unrelated parties.

### *Fiscal unity or merger*

The third rule that may limit the deduction of interest is connected with the acquisition by a Dutch company of a Dutch target company, which subsequently form a fiscal unity or merge as a result of which the interest due on the acquisition debt is offset against the operational profit of the Dutch target company. This is only allowed in so far as the acquisition debt does not exceed 60% of the acquisition price.

There is an annual allowance of EUR 1 million. The percentage goes down by 5% of the acquisition price each year, until it reaches 25%. The excess interest on the acquisition debt can only be offset against profits generated by the acquisition company itself. If the acquisition company itself has insufficient profits, the excess can be carried forward.

## Other tax aspects

Other tax matters to be aware of are:

- (a) losses incurred from holding and financing activities are ring-fenced and may not be used to set off against the operating income of the Dutch target;
- (b) tax losses can be carried back one year and carried forward for nine years;
- (c) the Netherlands does not levy a withholding tax on arm's length interest due or paid, irrespective of where the recipient is resident; and



(d) the Netherlands does not levy a capital duty on the capitalization of a Dutch company.

## 21. What forms of exit are available?

In a solvent situation the most common forms of exit are an IPO, a trade sale (either a sale of shares or a sale of the underlying business) or a secondary buy-out.

It is also fairly common for private equity funds to achieve a return on their investment during the life of the investment by undertaking a leveraged recapitalization. In that case, the return takes the form of a dividend and/or some other form of capital distribution or buy back.

## People's Republic of China

### 1. What structures do private equity funds typically use to manage their funds?

In China, international private equity funds typically use offshore limited partnership structures to manage funds raised from their investors. The partnership is commonly constituted in the Cayman Islands for tax purposes. The investors hold limited partnership interests in the partnership and there is a general partner who takes day-to-day management control of the partnership and its operations. The general partner typically delegates the investment management functions to an investment manager or investment adviser outside China, for example in Hong Kong, to advise on the fund management activities in China. To facilitate deal sourcing and liaison with portfolio companies, the private equity funds typically set up resident representative offices or subsidiaries in China.

Onshore structures have been used primarily by local firms managing Renminbi-denominated funds, but since the amendment of the Partnership Enterprise Law that came into effect in 2007, a number of international funds have also set up Renminbi-denominated funds in China.

Under the People's Republic of China (PRC) legal framework, Renminbi-denominated funds can be structured as either:

- (a) a limited liability company;
- (b) a joint stock company;
- (c) a trust; or
- (d) a limited partnership.

A limited partnership is the most commonly adopted structure.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in China?

An offshore private equity fund need not be licensed in China, if no direct revenue-generating fund management activities are carried out in China. Representative offices or subsidiaries set up by offshore funds are typically just registered with the local business registration authorities without any special industry approval.

Renminbi-denominated funds (other than a trust) are typically registered with the competent business registry in China.

### 3. Are there any approvals required for investments by foreigners in China and, if so, what is the process?

#### Foreign investment restrictions

The procedures for an acquisition of a PRC target company by a foreign investor may vary depending on the location and the ownership structure of the Chinese party. In general, the acquisition will have to be approved by the Ministry of Commerce (**MOFCOM**) or its local counterpart depending on the size and business of the target company and other factors. For project-based target companies such as manufacturing enterprises, verification by the National Development and Reform Commission (**NDRC**) or its local counterpart is additionally required before MOFCOM approval. After approval, the transaction must be registered with the local bureau of the State Administration for Industry and Commerce (**SAIC** and its local bureau **AIC**) within one month.



The general approval authority rules described vary in particular cases. The central government has promulgated a number of individual regulations, notices and policies with special rules for determining and delegating the approval authority for projects and transactions in certain sectors or industries. For example, sector-specific authorities, such as the China Banking Regulatory Commission and the China Securities and Regulatory Commission are the primary regulators for their respective industries. Local authorities often publish individual rules to further refine delegation of approval powers within their localities. Accordingly the precise approval authority for any given project, company or transaction can only be determined after careful consultation of all of the relevant rules.

On 19 January 2015, MOFCOM released a draft of a new foreign investment law for public comment. The draft law is meant to replace the existing foreign investment laws. When passed, this law would stand as a historic event in China's reform and liberalization. The draft law aims to establish a framework for the regulation and monitoring of foreign investment in the areas of market entry and ongoing compliance, while leaving the corporate form and governance issues to other legislation such as the PRC Company Law (**PRC Company Law**).

Compared to the current law, the draft law adopts a much broader definition of 'foreign investment' based on a 'substance over form' principle. The draft law proposes a complete overhaul of the current pre-establishment approval regime governing foreign investment by replacing it with a market entry review and an information-reporting regime. A Negative List replicating the current practice in China (Shanghai) Pilot Free Trade Zone would replace the decades-old case-by-case examination and approval system. An investor would only be required to obtain market-entry approval if the investment is in a sector on the Negative List. Otherwise, the investor could simply report the establishment of or investment in the FIE. Another notable development is the codification of national security review as formal law. Many hurdles need to be cleared and a consensus built before the draft law can be presented to the Chinese legislature for its first formal legislative review. The whole process may take up to two years or more.

#### *MOFCOM*

As mentioned above, all foreign investments in Chinese companies and assets are subject to government approvals. The government authority in-charge of overseeing all foreign investments is the Ministry of Commerce (**MOFCOM**). Depending on the size of the investment and the industrial sector concerned, approval from the local or central MOFCOM is required. Specifically, investments above USD 300 million in the encouraged or permitted industrial sectors, and investments above USD 50 million in the restricted industrial sectors must be approved by the MOFCOM at the central level. Investments of a smaller scale are approved by the relevant local counterparts of MOFCOM. Further, if the acquisition by a foreigner meets certain thresholds relating to market share, assets and turnover, anti-trust filings must also be submitted to the Anti-Monopoly Bureau under MOFCOM for examination.

#### *Industry guidance*

The PRC Regulations for Guiding the Direction of Foreign Investment and the Catalogue for Guiding Foreign Investment in Industries (**Foreign Investment Catalogue**) serve as general indicators of current policy governing foreign investment in various industries. The Foreign Investment Catalogue is revised every few years to embody changes in PRC foreign investment policy. These documents provide certain policy incentives or disincentives depending on whether a project is deemed 'encouraged', 'permitted', 'restricted' or 'prohibited'. An enterprise in the 'encouraged' businesses category, for example, may qualify for local (and generally more lenient) approval processes. An enterprise conducting 'restricted' activities, on the other hand, may be subject to additional scrutiny by higher approval authorities during the establishment process and may in some cases be required to have its Chinese partner(s) control more than 50% of its equity.

For acquisition of companies in the sensitive industries with a bearing on national security, (e.g., major agricultural products, energy and resources, infrastructure), the acquisition may need to undergo a national security review led by MOFCOM.

In some industrial sectors (such as telecommunications and financial services), qualification requirements and caps on equity participation are imposed on the foreign shareholder. For example, under current regulations, foreign ownership in companies providing basic telecommunications services and value-added telecommunications services in China is respectively capped at 49% and 50%. The foreign investor must also satisfy certain qualification requirements. For foreign investments in these highly regulated sectors, prior to obtaining MOFCOM approval, approval from the relevant industry regulators normally would need to be sought.

#### *Proposed amendments to the Foreign Investment Catalogue*

On 4 November 2014, the NDRC released a draft 2014 version of the Foreign Investment Catalogue which was open for public comment until 3 December 2014. The new draft promises to open up a significant number of currently restricted and prohibited sectors to foreign investors. Compared to the 2011 Catalogue, the draft 2014 Catalogue reduces the number of restricted sectors for foreign investment from 79 to 35, and removes shareholding limitations in a wide array of industries. As of the date of this publication, the final version of the new Foreign Investment Catalogue has not yet been released. In general, the following approvals may be required:

- (a) for investment involving fixed assets and certain strategic sectors such as energy, infrastructure and automotive, approval from the NDRC;
- (b) for the acquisition of shares in Chinese public companies, approval from the China Securities Regulatory Commission; or
- (c) for targets involving disposal or dilution of state-owned interests, approval from, or registration with, the State-owned Assets Supervision and Administration Commission.

#### **Exchange controls**

China's national currency, the RMB, is not freely convertible into other currencies. Nevertheless, China has introduced a form of current account convertibility, under which joint ventures may purchase foreign exchange for current account expenditures without the necessity of obtaining government approval. China also permits the conversion of RMB into foreign exchange for remittances of after-tax profits or dividends to foreign investors in equity joint ventures. Foreign exchange remittances and receipts must be cleared through authorized banks designated to handle foreign exchange transactions. Instead of government approval for foreign exchange remittances and receipts, the designated banks examine the documentation for the underlying transaction to ensure that the proposed payment or receipt qualifies as a current account item. Joint ventures also have access to the inter-bank market for the purchase and sale of foreign exchange through the designated banks.

Government approval is still required for the purchase and remittance of foreign exchange for certain capital account transactions (generally, items of a non-trade, nonrecurring nature, such as investment in China, real estate purchases, repayment of principal of foreign currency loans and contributions to registered capital). The general trend is to reduce government approval and some capital account transactions can now be processed by authorized banks. More flexibility in the free trade zones is also seen.

#### **Approval of foreign exchange transactions**

There are detailed rules specifying the approval authority which local banks and local branches of SAFE exercise over each type of foreign exchange transaction. These rules change periodically but the general trend is for SAFE to delegate more authority to approve foreign exchange transactions to local banks.



### *Remittance issues*

While PRC statutes allow multiple forms of payment for a merger and acquisition transaction, some foreign buyers may opt to pay the purchase price for the relevant interest or assets transferred, utilizing foreign currency funds currently held outside of China. This means that, in transactions involving foreign investors acquiring targets in China, generally, the 'inward remittance' and 'settlement' aspects of foreign exchange control are more relevant.

### *Payment to a foreign seller outside of the PRC*

Where the seller in either an indirect acquisition or a direct acquisition is a foreign company with a bank account outside of China, the foreign buyer typically pays the purchase price offshore to the foreign seller. Since such payments do not cross the PRC border, SAFE would not have jurisdiction over them.

### *Payment to a seller in the PRC*

- (a) On a share sale, if the transaction involves a seller that must be paid in China, the foreign investor will have to remit the purchase price into the PRC. The purchase price will typically be remitted in foreign exchange to a special account that the seller establishes for the specific purpose of receiving these funds. The PRC seller must then submit supporting documents to the bank to convert the foreign exchange in the special account into RMB, and remit the RMB out of the special account. With the internationalization of RMB promoted by the PRC government, a foreign buyer may pay the purchase price with lawfully obtained RMB, which is subject to less scrutiny in practice. Under the Foreign M&A Regulations, a foreign buyer may also pay the purchase price with listed shares or pre-IPO shares of an offshore company (upon MOFCOM approval), if the shares fulfil certain conditions and comply with required approval procedures.
- (b) *Round-trip investment*: On 21 October 2005, SAFE issued the Notice on Foreign Exchange Control Issues Relating to Financing and Round Trip Investments by Domestic Residents through Offshore SPVs, commonly known as '**Circular 75**', which had been the main regulation governing foreign exchange administration of a Chinese investor's 'round-trip' investment. On 14 July 2014, SAFE replaced Circular 75 with the Notice on Foreign Exchange Administration of Overseas Investments and Financing and Round-Trip Investments by Domestic Residents through Special Purpose Vehicles (**SAFE Circular 37**). Under SAFE Circular 37, registration/change in registration rules apply to PRC individuals and entities making a 'round-trip' investment (i.e., a domestic investment made, *inter alia*, directly or indirectly through a SPV to obtain relevant ownership, right of control or right of management or administration, etc.) in an indirect offshore acquisition. If the foreign parent company of the PRC target is ultimately controlled by PRC individuals and/or entities, the foreign investor will need to consider regulatory requirements under SAFE Circular 37 (although the obligations are largely on the PRC individuals and/or entities themselves).

## **4. Who are the relevant regulators in China and how much interaction would one generally expect when undertaking a buyout?**

The relevant regulators are:

- (a) Ministry of Commerce (**MOFCOM**) - responsible for overseeing all foreign investments in China and for approving relevant transaction documents such as the share purchase agreement and the constituent documents of the investee company, as well as anti-trust filings and national security review;
- (b) National Development and Reform Commission (**NDRC**) - responsible for formulating and implementing strategies for national economic and social development, industrial policies and

price policies. It is also responsible for examining and approving major infrastructure, energy, and other restricted projects;

- (c) State Administration for Industry and Commerce (**SAIC**) - responsible for business registrations for all entities in China, market supervision and related administrative enforcement;
- (d) State Administration of Foreign Exchange (**SAFE**) - responsible for supervising all foreign exchange transactions;
- (e) China Securities Regulatory Commission (**CSRC**) - responsible for regulating the securities market, Chinese listed companies and licensing of securities and futures companies; and
- (f) State-owned Assets Supervision and Administration Commission (**SASAC**) - responsible for the reform, restructuring, and sale of state-owned enterprises.

Foreigners investing in China should expect a high level of interaction with the various government authorities, both at the local level and, if required, at the central level, given that government approval would in practice be subject to the discretion of relevant officials (see question 4 above).

## 5. How are buyouts typically undertaken in the private and the public markets?

### Private companies

A buyout is generally undertaken by way of a private acquisition that is concluded after negotiations between the parties. The parties enter into a sale and purchase agreement which records the terms and conditions of the acquisition as well as the rights and liabilities of the parties involved. In recent years, it has been increasingly popular for buyouts of a private company to take place following an auction process where several competing bidders are invited by the seller to bid for the target company and where the seller ordinarily concludes a sale and purchase agreement with the bidder that offers the highest price and the most favorable contractual terms. This type of auction process is required in the context of an acquisition involving state-owned assets, which is subject to special rules and procedures (including, but not limited to, public notification of the proposed sale, asset appraisal and minimum price requirements).

### Public companies

In buyouts involving public listed companies, a buyout may be undertaken by way of a private acquisition coupled with a takeover bid, which must comply with applicable legal and regulatory provisions that govern the process of the takeover. It is noteworthy that there is no 'squeeze out' right under PRC law.

## 6. What is the typical corporate structure used when doing a buyout?

The choice of the corporate structure used when undertaking a buyout is typically driven by a number of factors, including tax considerations, foreign ownership restrictions and timing for completion of the proposed transaction. Funds may undertake a buyout of an operating company directly or through an investment holding company. More elaborate structures are used on larger and more complex deals.

### Offshore/indirect acquisitions

An acquisition involving a PRC entity or business can either be structured as an offshore/indirect transaction or an onshore/direct transaction.

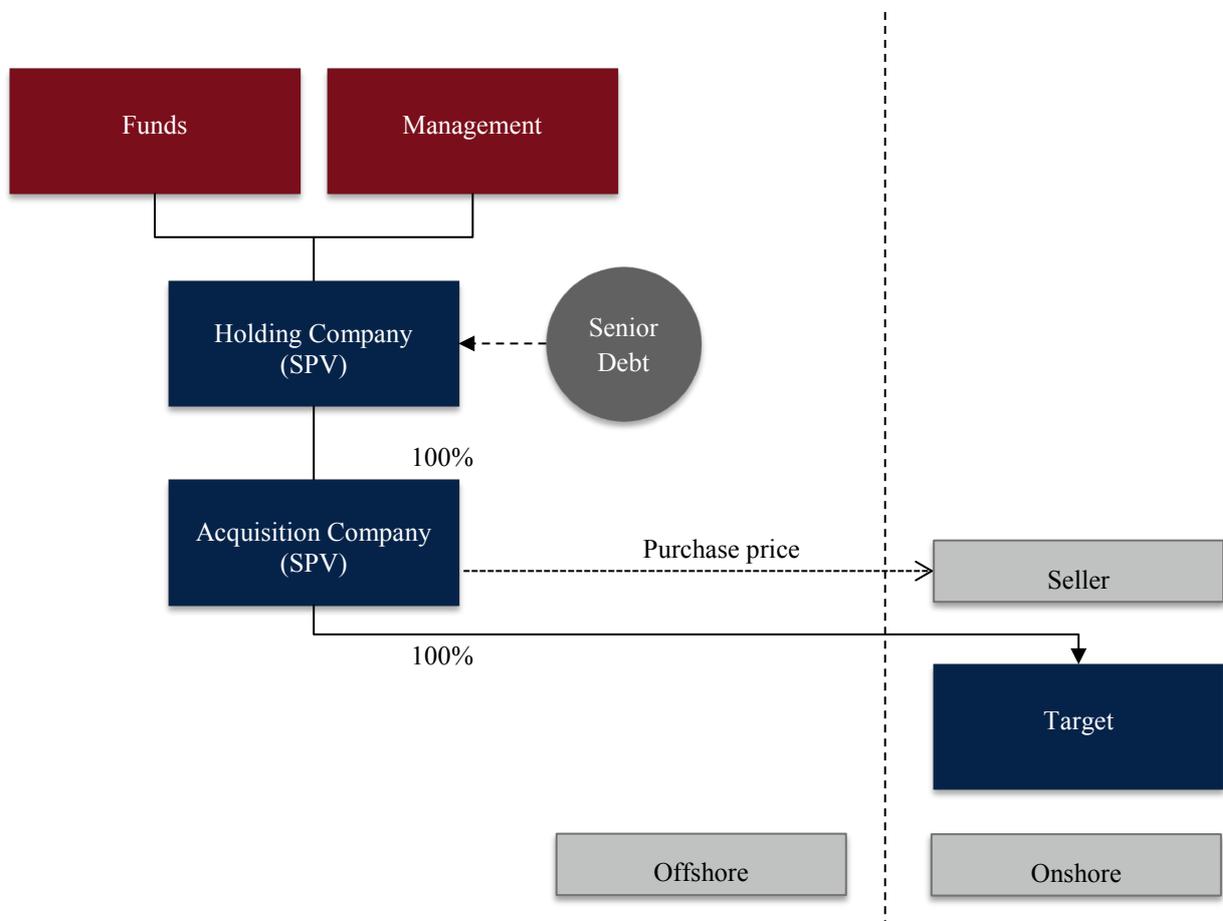


An offshore/indirect acquisition is only possible in the context of an equity transaction if the PRC target has a foreign parent or if the existing Chinese owner undergoes restructuring to set up a foreign holding company after obtaining requisite government approvals and completing relevant registrations. The benefits of adopting this type of acquisition structure include the flexibility of seeking a listing on a recognized stock exchange outside of China and rights tailoring of equity securities of the target company. Subsequent exit through a trade sale also would not be subject to PRC government approval (other than PRC anti-trust clearance which applies to both direct and indirect share transfers), which would otherwise be required in the case of a direct transfer of equity in the Chinese operating company by a foreign shareholder.

A buyout for an offshore/indirect transaction typically would be undertaken through two levels of newly-incorporated companies as follows:

- (a) a holding company which receives funding from the fund and from any managers who are invited to invest in the company (**Holding Company/SPV**). The Holding Company/SPV is typically incorporated in the BVI or another low tax jurisdiction. This is also the entity that receives debt funding from offshore bank(s); and
- (b) a company which purchases the target (**Acquisition Company/SPV**). Acquisition Company is commonly incorporated in Hong Kong.

A structure illustrating the above is as follows:



### Onshore/direct acquisition of shares

A direct acquisition will take place in the PRC and will therefore be subject to full PRC approval requirements, which may be time-consuming and involve government discretion, (i.e., the PRC authorities may withhold approval if they perceive problems with the transaction).

The foreign buyer in a direct share acquisition generally assumes all existing or contingent obligations and liabilities of, and restrictions applicable to, the PRC target company in proportion to its equity in the target, unless explicitly carved out or excluded before or during the transaction.

If the equity of a Chinese domestic company is acquired, the foreign buyer is required to pay at least 60% of the total consideration within six months from the date the Chinese domestic company is issued a revised business license following the acquisition, and pay the balance within one year from the issue of the business license. To overcome this restriction, the acquisition may be made in stages or part of the consideration would need to be structured as other types of payments to the seller.

## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

Typically, before negotiations begin for a buyout, the investor and the target company sign a confidentiality or non-disclosure agreement.

Except in the case of an auction process, negotiation usually begins with the circulation of a term sheet or memorandum of understanding. While the term sheet or memorandum of understanding is generally stated to be non-binding in nature, the Chinese parties usually expect that all the terms contained in the term sheet or memorandum of understanding will eventually be replicated in the formal agreements if the transaction proceeds.

Prior to beginning detailed due diligence and negotiation of contractual terms, a well-advised investor may also request a period of exclusivity, during which the seller cannot 'shop' the target. This arrangement may be included within the confidentiality agreement or in a separate exclusivity agreement.

After due diligence in relation to the target company is completed, the share purchase agreement, subscription agreement or investment agreement is executed by both parties. Typically, a shareholders agreement (and, in the context of a Sino-foreign joint venture company, a joint venture contract among the shareholders) is also entered into by the investor, the target company and the existing shareholders if the company is not wholly acquired.

Some other relevant documents that may be prepared when undertaking a buyout include employment agreements between key employees and the target company, an employee share option plan, management or service agreements and a registration rights agreement.

In the context of buyouts involving public listed companies, additional documentation may be required to effect the takeover bid or the mandatory general offer obligation that is triggered as a result of the buyout transaction. The form and content of the relevant documentation depends on, among other things, the legal and regulatory requirements of the jurisdiction of the target company's place of incorporation and the stock exchange on which its shares are listed.

### Banking

The main banking document is the facilities agreement under which the terms of the loan made to the company are documented. Typically, separate security documents, by which the target company provides security for the loan granted to it, are executed. The nature of the security depends on the circumstances and can include fixed and floating charges.

If there are different debt providers, their relative positions would depend on subordination and other contractual arrangements negotiated between the parties. Where there are different types of debt finance, subordination is typically implemented through an intercreditor agreement.



## 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

Generally, the buyer should ensure that the acquisition documents include appropriate closing conditions, as well as a set of comprehensive and appropriate representations, warranties and undertakings in relation to the target entities. Part of the purchase price may be withheld or placed in escrow for a fixed period to meet any warranty or indemnity claim. Warranty & indemnity insurance is being used in some deals although compared to other jurisdictions this is still a relatively new development and therefore still not common in China.

## 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

Management may be in a position of conflict due to the contractual obligations it owes to the target company under any service agreement.

Under the PRC Company Law, directors and senior management personnel (defined to include general manager, deputy general manager(s), financial controller, board secretary of listed companies, and other senior management personnel specified in the company's constituent documents) owe the company a general fiduciary duty to act in the best interests of the company and not to put his or her other interests in conflict with those of the company.

Directors of a Chinese listed company are required to abstain from voting on affiliated matters. Generally, listed companies are also required to have independent directors, who must comprise not less than one-third of the total number of directors. In the case of a management buyout, the percentage of independent directors on the board must be one-half or more. The listed company must engage a licensed appraiser to issue a valuation report and the buyout must be approved by at least two-thirds of the independent directors and a simple majority of the shareholders. The independent directors are also required to engage a financial advisor to issue an opinion in relation to the buyout.

There are also additional rules regulating a management buyout of state-owned entities. Under these rules, management is not allowed to participate in major decisions relating to the sale, financial audit and asset appraisal. If the management personnel are responsible for the decline of operational results of the company, they are prohibited from participating in the buyout.

## 10. How are the equity arrangements typically regulated in a buyout?

The equity arrangements in a buyout are typically regulated by a shareholders agreement (and, in the context of a Sino-foreign joint venture company, a joint venture contract). Further, the constituent documents of the relevant entity is often amended to include the specific share rights that attach to the relevant classes of security to be issued in relation to the buyout.

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

In China, a company can either be a limited liability company (LLC), which does not have an issued share capital but rather a registered capital, or a joint stock limited company, which has an issued share capital and which is the only type of PRC legal enterprise that can be listed. Limited rights tailoring (namely, differentiation of distribution rights) is permitted for an LLC.

In the context of an acquisition involving a PRC entity or business, if different classes of equity with different rights are intended to be issued to different stakeholders, the acquisition is typically structured as an offshore/indirect transaction. Common jurisdictions of incorporation of the relevant entity that would typically make an indirect investment include Hong Kong, the Cayman Islands and the British Virgin Islands. Generally, the laws of these jurisdictions are fairly flexible in relation to the

classes of equity security that can be granted, or the level of rights tailoring that can occur between different stakeholders (e.g., management and the private equity fund) in a buyout. Shares having any type of rights may be created as decided among the shareholders of the company. Different classes of equity are not possible in the case of an onshore/direct transaction.

Typically, the classes of equity security include ordinary shares. Preference shares and convertible debt instruments are favored by venture investors.

## **12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?**

Typically, the shareholders agreement (and, in the context of a Sino-foreign joint venture company, a joint venture contract among the shareholders) sets out the relationships, rights and obligations among the investor, the target company and the existing shareholders of the target company. The shareholders agreement/joint venture contract and the articles of association would govern matters concerning board constituency, differential director voting rights and the removal of directors. It is common for private equity funds to have specific appointment and removal rights in respect of a certain number of directors in their portfolio companies.

For an LLC, the number of directors on a board of directors needs to be between three and 13. For companies with a relatively small number of shareholders or where the scale is small, they can have an executive director instead of a board of directors. For joint stock limited companies, the number of directors needs to be between five and 19. For LLCs established by two or more state-owned enterprises, the board of directors must also include employee representatives. Each director has one vote.

## **13. What measures are commonly used to give a fund some level of control over key operating and financial decisions made by an investee company?**

The fund usually has representation on the board of the company and may request that certain matters are subject to supermajority vote or, where a different class of shares are held by the fund (e.g., preference shares), the veto right of shareholders of that class if it wishes to have a say in the management and direction of the company. Representation on the board may also include a presence on the audit and remuneration committees. A shareholders agreement or the constituent documents of a company can therefore entrench the fund's right to appoint a majority of members to the board for privately held entities and the requirement to subject certain matters to supermajority vote or the veto right of shareholders of a particular class.

The fund may create particular corporate governance and approval authority workflows to impose restrictions on the management in undertaking any fundamental matters (such as a major acquisition or disposal or large projects) without board approval. It may also secure direct involvement in the daily management of the portfolio company by nominating key officers such as the chief executive officer, the chief financial officer and the chief technology officer.

## **14. What employment terms are generally imposed on management in a buyout?**

Long-term agreements are entered into with key personnel of the target company to ensure continuity. Key employment terms include non-compete clauses, confidentiality clauses and provisions for 'gardening leave' to mitigate risks when key personnel resign. Incentive plans tied to company performance may also be introduced to ensure long-term retention of management. For private equity funds with management incentive programs, the terms offered to Chinese employees typically mirror those in mature markets (including, for example, the typical good leaver and bad leaver provisions).



PRC labor laws are generally favorable to employees and termination must be for cause. To enforce post-termination non-compete undertakings, the employer is required to provide reasonable compensation to the employee after his or her departure.

## 15. What incentives can be offered to management and how are they typically structured?

Generally, incentive plans for management are structured on a long-term basis. However, short-term incentives based on annual results are not uncommon. If the fund decides to take the company public, stock options (with or without lock-ups) are a typical incentive available.

Under a notice issued by SAFE, companies that implement employee stock incentive plans are required to obtain prior approval from SAFE. Furthermore, the Chinese employers are required legally to make relevant filings of their employee stock option plan with the local tax bureau.

Under existing foreign exchange regulations, there are annual limits on the amount of foreign exchange that can be converted into Renminbi by a PRC individual. Senior executives who derive stock option income above these limits will have difficulty in converting the foreign exchange received in their bank accounts.

## 16. How are buyouts typically debt financed and secured?

### Finance

The debt structure generally consists of senior debt. The senior debt is usually made available by banks and financial institutions and the types of senior debt include term loans and revolving credit facilities.

In light of the lending, borrowing and foreign currency restrictions in China, the financing will need to be carefully structured to ensure that it is provided at the right level (both in terms of the entity that will require the funding as well as the ability to obtain relevant security for the loan) and to secure cash for servicing of the debt.

### Security

Security is typically obtained through the usual mortgages and charges (fixed and floating) over the acquired assets, or the shares acquired, subject to compliance with the financial assistance provisions of the jurisdiction of incorporation of the target company and applicable restrictions on the provision of security by PRC entities. Usually, the relative priority of security depends on the contractual arrangements negotiated between the parties.

## 17. Are there financial assistance issues to consider when undertaking a buyout?

The concept of financial assistance under the law of the PRC only applies to listed companies. Except in the context of listed companies, there is no particular prohibition on a PRC company providing security or other forms of financial assistance in connection with an acquisition of equity interests in that PRC company or its direct or indirect holding company.

However, Article 16 of the PRC Company Law contains a general restriction on PRC companies providing third party guarantees or security whether or not the secured indebtedness is for the purpose of an acquisition. Where a PRC company provides a guarantee or security to guarantee or secure the liabilities of its shareholder(s) or a person who actually controls the PRC company, the provision of the guarantee or security must be approved by the shareholders. Approval must be given by a shareholders' resolution passed by more than half of the shareholders present at the meeting and

entitled to vote. The shareholders whose debts are being secured by the company and any shareholder controlled by the *de facto* controller are not entitled to vote.

In relation to listed companies, under Article 8 of the *Takeover Rules of Listed Companies*, the board of directors of a listed PRC company is prohibited from approving the provision of any form of financial assistance involving the use of the resources of the PRC company that is the subject of the proposed takeover. Moreover, companies limited by shares that are seeking to be listed offshore are required under the *Mandatory Provisions to be Adopted in the Articles of Association of Companies Seeking Offshore Listing* to include in their constitutional documents restrictions on themselves and their subsidiaries from providing any form of financial assistance to their acquirers. Accordingly, offshore-listed PRC companies and their subsidiaries will not be able to provide any financial assistance in connection with the acquisition of shares in those companies or their parent companies due to those restrictions in their constitutional documents.

If the beneficiary of a guarantee/security is a party located outside China, the restrictions relating to foreign security will also apply.

## 18. What are the implications under the corporate benefit laws of China for a company providing financial assistance?

The laws of PRC do not apply a ‘corporate benefit’ or ‘commercial benefit’ test to a PRC company in relation to whether or not a transaction ought to be entered into by a PRC company.

However, PRC Company Law imposes a general duty of diligence and a general duty of loyalty on the directors, supervisors and senior managers of a PRC company. They should not, by taking advantage of their functions and powers, accept bribes or other unlawful income nor misappropriate the property of the company. The duties are similar to fiduciary duties under common law, but the exact scope of these duties is not clearly described in the PRC Company Law.

If the directors, supervisors or senior managers of a PRC company abuse their powers or rights, and this results in losses to their company, those officers will be required to indemnify the company for all losses incurred by the firm. For instance, if a director of a PRC company has certain specific interests in another group to which security will be provided by the PRC company, and he/she votes in favor of the provision of security by that PRC company at the board meeting for the benefit of his/her own interests, and subsequently the PRC company suffers a loss arising from its provision of security, the director may be liable for that loss. However, the law does not clearly stipulate what constitutes an act of abuse and how to quantify the loss suffered by the PRC company. This would, therefore, be determined in the PRC court’s discretion.

When considering providing financial assistance in relation to the acquisition of a PRC company’s equity interests or equity interests in its holding company, the directors of the PRC company must:

- (a) check and ensure that they are not an interested party in relation to that financial assistance; and
- (b) if the guarantee/security is granted to guarantee or secure the debts of the company’s shareholders, ensure that shareholders’ approval is obtained in accordance with Article 16 of the PRC Company Law (see the answer to question 17).

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

PRC insolvency laws provide for a basic ranking of claims among debtors of the company.

The general law of property applies in these situations and secured creditors take priority over unsecured creditors. There are exceptions to this rule, for example, where the security was created in



circumstances where it may be challenged (e.g., if it constitutes a ‘preference’). As between secured creditors, a legal charge prevails over an equitable charge, unless the equitable charge was created first and the legal chargee knew of the prior charge.

It should be noted that the PRC Enterprise Bankruptcy Law provides for a class of preferential creditors, such as employees whose wages and social security payments are unpaid, that take priority over unsecured creditors in the event of a winding up of an enterprise legal person in China, including, private enterprises and foreign invested enterprises (**FIEs**).

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

The common key tax issues are set out below.

### Foreign Invested Enterprise (FIE) status

If the target company is an FIE, it may enjoy tax preferential policies available to an FIE. Note however that, under the Enterprise Tax Law that came into effect on 1 January 2008, many of the preferential treatments that were previously available to FIEs are being phased out.

### Stamp duty

For equity acquisitions, the stamp duty would generally be 0.05% of the share transfer price, and will generally be imposed on both the buyer and the seller. However, if the company is a joint stock limited company listed on a PRC stock exchange, transfer of the listed shares will be subject to 0.3% stamp duty on the share transfer price.

### Tax on capital gains

If the seller is an enterprise in China, its capital gains derived from the sale of shares to a foreign purchaser are treated as part of that enterprise’s taxable income for enterprise income tax purposes. Enterprise income tax (**EIT**) is generally levied at a rate of 25% if it is a resident enterprise, or 10% if it is a non-resident enterprise and the gain is not connected with a permanent establishment in China.

If a foreign investor acquires a Chinese company, real property situated in China or property owned by an establishment or place situated in China (collectively, **China Taxable Property**) through an indirect share acquisition (i.e., by buying the shares of the target company’s overseas holding company), the seller of the shares may be subject to EIT in China on capital gains based on China’s indirect transfer rules. These rules have been effective since 3 February 2015, but apply to indirect transfers that occurred since 1 January 2008 which have not yet been assessed for tax by the tax authorities. An indirect transfer generally will be ‘re-characterized’ as a direct transfer if it lacks reasonable commercial purpose and does not fall within any safe harbors, and the buyer should be the withholding agent. If neither the withholding agent nor the offshore seller withholds or pays the taxes due, the PRC tax authorities may impose on the withholding agent a penalty ranging from 50% to three times the amount of the unpaid tax. Certain indirect transfers will be deemed to lack reasonable commercial purpose without any further analysis if:

- (a) 75% or more of the value of the offshore target’s equity is directly or indirectly derived from Chinese Taxable Property;
- (b) 90% or more of the total assets (excluding cash) of the offshore target, at any time during the one-year period preceding the indirect transfer of Chinese Taxable Property, comprise direct or indirect investments located in China, or 90% or more of the revenue earned by the offshore target, during the one-year period preceding the indirect transfer of Chinese Taxable Property, is directly or indirectly sourced from China;

- (c) the offshore target and its underlying affiliates that directly or indirectly hold Chinese Taxable Property have only completed the formality of registration in their counties (or regions) and fulfilled all legal organizational requirements, but the actual functions they performed and the risks they assumed are too limited to prove that they have economic substance; and
- (d) the foreign income tax payable on the indirect transfer is lower than the possible Chinese tax payable on the direct transfer.

### Tax on dividends

If the shareholder is an enterprise in China, dividends from another PRC subsidiary are generally exempt from enterprise income tax. An exception is if the investee's shares are publicly listed and held by the Chinese enterprise consecutively for less than 12 months. If the shareholder is a foreign company, withholding tax at the rate of 10% is generally levied on dividends received by the foreign company from its PRC investee.

## 21. What forms of exit are available?

In solvent situations, the common forms of exit are via initial public offerings or trade sales to strategic investors or to another private equity firm. Dual track exit processes are common, although very much driven by market conditions.

In insolvent situations, the company may still be sold to another private equity firm or strategic investor if the parties believe that they can derive better value from the insolvent company. In certain situations, the insolvent company may be placed into voluntary or involuntary liquidation and shareholders are returned any cash remaining after the creditors are paid.



## Peru

### 1. What structures do private equity funds typically use to manage their funds?

#### Foreign funds

Foreign funds may invest in Peru directly or through a local corporation. In our experience, foreign private equity funds investing in Peru usually manage their funds using a limited partnership registered in an offshore jurisdiction (such as the Cayman Islands or the British Virgin Islands).

#### Peruvian funds

Peruvian private equity funds are mostly set up as investment funds (*fondo de inversion*) and in a very few cases in another form e.g., a corporation.

Private equity funds are separated into two main types:

- (a) private equity funds registered in the Securities Public Registry (*Registro Público del Mercado de Valores*) (**SPR**); and
- (b) private equity funds not registered in the SPR.

The main characteristics of the two types of private equity funds are set out below.

#### *Registered - Public offer equity funds*

These are private equity funds registered in the SPR, whose quotas of participation:

- (a) have been offered by means of a primary public offer; or
- (b) even though they have been offered by means of a primary private offer, have registered the quotas in the SPR for secondary negotiation (i.e., the purchase and sale of securities previously issued by means of a primary offer).

This type of fund is subject to the control and supervision of the Securities Superintendence (*Superintendencia del Mercado de Valores*) (**SMV**) and must comply with a series of requirements provided by law. The SMV must approve the fund regulations, its internal standards of conduct and the standard agreement to be executed by the fund with each of its participants. The investments conducted by this type of fund are subject to certain rules, diversification requirements and certain restrictions set out in the applicable regulations.

#### *Unregistered - Private offer equity funds*

These are private equity funds not registered in the SPR, whose quotas of participation have been offered by means of a private offer and have not been subsequently registered in the SPR. This type of fund is not controlled or supervised by the SMV and is subject to the provisions stated in its regulations and the agreement executed by the fund with each of its participants. The law grants the SMV the right to request private information in relation to the operations and financial statements of this type of fund.

Note that a non-registered fund may also be structured as either a local or foreign corporation, in which case it would be treated as a private entity and could be subject to certain restrictions.

## 2. Do funds need to be licensed by any regulatory authority to conduct business in Peru?

### Registration requirements

Funds do not necessarily need to be licensed by a regulatory authority to conduct business in Peru. As stated in the answer to question 1, in Peru there are two main types of structures that private equity funds typically use to manage their funds (i.e., registered and unregistered private equity funds). Unregistered private equity funds do not need a specific license issued by a particular authority to conduct business in Peru, while registered private equity funds are subject to the control and supervision of the SMV.

In relation to both types of structures described above, the funds are usually managed by a Private Equity Fund Administrator Company (*Sociedad Administradora de Fondos de Inversion*). This too is an entity subject to the control and supervision of the SMV.

### Peruvian Private Pension Fund Administrators

To obtain investments from Peruvian Private Pension Fund Administrators (*Administradoras de Fondos de Pensiones*) (**AFP**), foreign private equity funds must comply with certain requirements established under the law and obtain authorization and registration from the Superintendence of Banks, Insurances and AFP (*Superintendencia de Banca, Seguros y AFP*) (**SBS**).

It is important to note that although both types of Peruvian private equity funds are eligible for investments made by the AFP, interests in unregistered private equity funds must first be included on the relevant AFP register. However, investments by an AFP in private equity funds, real estate funds, hedge funds, commodity funds, venture capital funds and infrastructure funds (collectively known as alternative investment funds) require previous authorization from the SBS.

## 3. Are there any approvals required for investments by foreigners in Peru and, if so, what is the process?

### Foreign investment approvals

There are no approvals required for investments by foreigners in Peru except for:

- (a) certain restrictions applicable to property ownership within a 50 km territory of the Peruvian border;
- (b) investments in the aeronautical sector; and
- (c) investments in the telecommunications sector, where reciprocity is not provided to Peruvian investors.

### Stability agreements

Please note that foreign investors may enter into legal stability agreements with the Peruvian government. Under these agreements, in exchange for investing a minimum amount (depending on the industry in which the investment is made), a foreign investor will receive a commitment from the government for a 10-year stability period in relation to the laws applicable at the time the investment is made (including, but not limited to, the tax regime, capacity to repatriate capital and pay dividends, the right to use the most favorable exchange rate, and the labor regime). In short, what this means is that any changes to the law during the stability period will not affect the investor.



#### 4. Who are the relevant regulators in Peru and how much interaction would one generally expect when undertaking a buyout?

If the buyout is conducted privately, there are no regulators involved in the transaction.

However, if the buyout is conducted in the public market (e.g., by a tender offer), then the SMV supervises the process, and the Lima Stock Exchange (**BVL**) will also be involved.

Investments in different sectors may also require the authorization of certain regulators. For example:

- (a) investments in the telecommunication sector require the approval of the Ministry of Transport and Telecommunications;
- (b) investments in the electricity sector involve the supervision of the Antitrust Authority (INDECOPI) in relation to antitrust clearance; and
- (c) investments in the banking sector require prior authorization from the SBS and involve the supervision of the SBS.

#### 5. How are buyouts typically undertaken in the private and the public markets?

##### Private context

A buyout of a private company is usually undertaken by a negotiated acquisition. The share or asset purchase agreement is drafted setting the terms and conditions of the acquisition, as well as the representations, covenants and liabilities of the parties.

It is also common for a buyout to be carried out by means of a direct investment in the target company by the fund. Consequently, the target company's capital stock will be increased, shares will be issued in favor of the private equity fund and the other shareholders' percentage of participation in the target company will be reduced.

##### Public context

A buyout of a listed company on the Lima Stock Exchange (**BVL**) can be undertaken either:

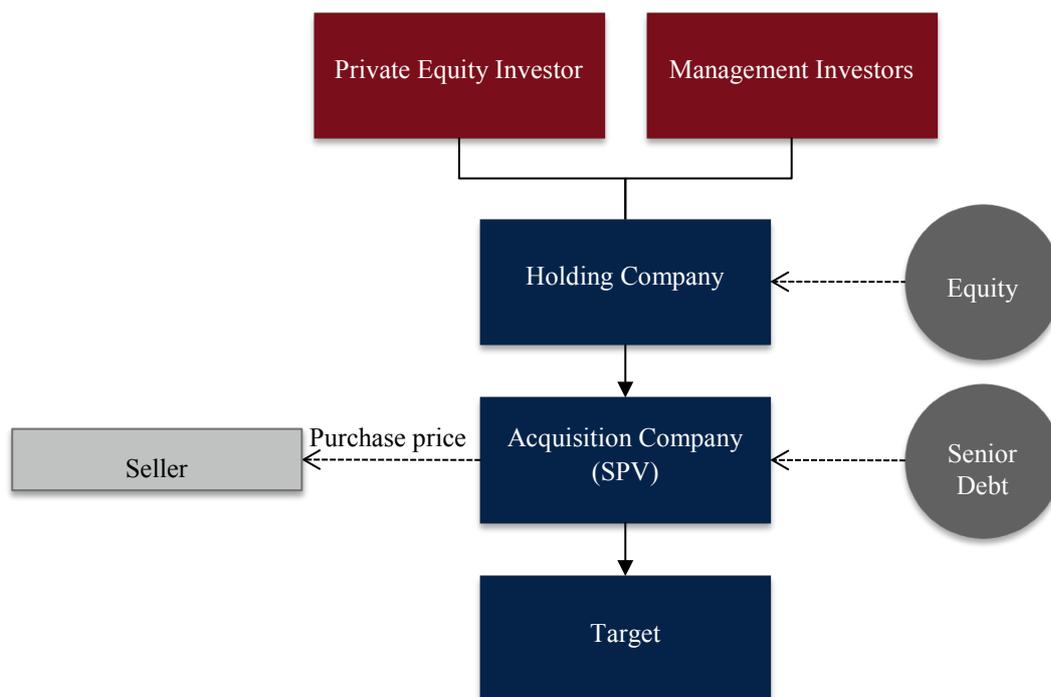
- (a) by a negotiated acquisition with the controlling shareholder, subject to a subsequent mandatory tender offer (regulated by the SMV and BVL); or
- (b) by a tender offer (regulated by the SMV and BVL).

Where the acquisition is negotiated with the controlling shareholder, the documents to be prepared and the clauses included in these documents are quite similar to those provided in a private acquisition. However, both in the case of a negotiated acquisition and where the acquisition is conducted by a tender offer, the Peruvian Securities Market Law provisions and the tender offer regulations must be followed.

The Peruvian Securities Market Law provisions and the tender offer regulations require any person who directly or indirectly acquires (in one or a series of transactions) a 'substantial interest' in a company that has at least a class of shares with voting rights registered with the SMV, to submit a tender offer (*oferta pública de adquisición*) (a 'mandatory tender offer').

## 6. What is the typical corporate structure used when doing a buyout?

It is common to see the following corporate structure when doing a buyout in Peru:



### Corporate structure

The typical corporate structure used when doing a buyout generally consists of incorporating a wholly-owned Peruvian subsidiary that is a special purpose vehicle (Acquisition Company SPV) that will carry out the acquisition of the target company and act as the holding company. The Acquisition Company will also receive the financing for the acquisition, and in some instances, it will be merged with the target company following completion.

Another option is for a foreign company to acquire the target company directly and act as the holding company/acquisition vehicle.

It is important however that each option be analyzed from a tax standpoint before deciding on the structure.

In relation to the financing of the transaction, it is common to see different layers of debt, which commonly include senior debt obtained from financial institutions and mezzanine debt obtained from specialized mezzanine debt investors. The financing structure may also include a second lien financing.<sup>29</sup> This structure can be implemented through a tower structure of special purpose vehicles to achieve structural subordination between senior and junior lenders.

### Acquisition Company SPV

The Acquisition Company SPV is commonly in the form of a *Sociedades Anónimas (SA)*, which is the preferred form of legal structure for doing business in Peru. It provides limited liability and is structured to allow the separation of management from ownership. For its incorporation it requires a minimum of two shareholders (either local or foreign individuals or companies).

<sup>29</sup> The number of layers of debt set up for the acquisition may vary depending on each particular transaction and the tax implications related to the transaction.



The capital of corporations is represented in shares, and there are no limitations on their transfer (except as otherwise agreed by shareholders in the bylaws or shareholders agreement). The governing bodies of the corporation are the shareholders' meeting, the board of directors and the general manager.

In addition, the Peruvian Corporations Law (**Corporations Law**) includes two special types of corporations:

- (a) closely held corporations; and
- (b) publicly held corporations.

Closely held corporations have the following characteristics:

- (a) a minimum of two and maximum of 20 shareholders;
- (b) certain rules apply to the transfer of shares, such as the shareholders' right of first refusal (although agreements in the company's bylaws or shareholders agreements to the contrary are allowed), and in some cases, the consent of the company (which should be agreed in the company's bylaws);
- (c) the shares in a closely held corporation cannot be listed on a stock exchange; and
- (d) it is optional for this type of corporation to have a board of directors.

Publicly held corporations have the following characteristics:

- (a) all shares must be registered in the **SPR**;
- (b) no limitations apply to the transfer of shares, and any agreement purporting to restrict the transfer of shares will not enforceable against the company; and
- (c) the company is subject to supervision by the **SMV**.

Except for these special rules, closely held corporations and publicly held corporations are subject to the same rules applicable to ordinary corporations.

## 7. What transaction documentation is usually prepared when undertaking a buyout?

In the case of buyouts negotiated in a private context, the most common transaction documents prepared are set out below.

### Corporate

The documents are:

- (a) a share purchase agreement;
- (b) a shareholders agreement entered into by and among the company acquiring the target company and its remaining shareholders; and
- (c) an escrow agreement.

Additionally, there may be several ancillary transaction documents prepared depending on the nature of the deal. These may include non-compete agreements, management agreements, bring down certificates, share ledger entries and resignation letters of officers.

## Financing

The typical documents are:

- (a) a loan agreement (most commonly a senior facility agreement); and
- (b) a security agreement over the shares or assets of the target company, including cash flows.

### 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

In a private context, buyer protections usually take the form of negotiated warranty and indemnity coverage from the seller (being either the shareholders in a share sale or the company from which the business and assets are being acquired in an asset sale). The terms of the protection vary from transaction to transaction. It is quite normal however to expect that limits are placed around any warranty and indemnity coverage, including claim thresholds and caps, time limits and adjustments for items otherwise disclosed or accounted for. Other types of guarantees, such as placing funds in escrow or guarantee trust, holding back part of the purchase price and security interests are also common.

Another common protection mechanism is to structure the acquisition as a two-step transaction, in which a controlling package of the target company is acquired as a first step. The remaining shares are subject to a put/call agreement which is exercised if certain ratios and conditions are met.

### 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

There are laws regulating how conflicts of interest are managed in a typical management buyout. Peruvian corporate law provides that the board of directors of the company may not adopt resolutions that are either not in the best interests of the company or in their own interest or in the interests of related parties. Management of the company may be held liable, jointly and severally, with the board members, if it participates in acts for which board members may be held liable or, being aware of those acts, does not inform the board or the shareholders' meeting about them. Notwithstanding this, there are no other specific provisions regulating conflicts of interest in relation to management and directors, so it is important to ensure that they are aligned with the buyout transaction to be carried out. Favorable conditions (e.g., bonuses) can be set in return for a successful buyout operation. These rules apply for both listed and unlisted companies.

It is not common for protocol letters to be executed between the company and its management in relation to a possible transaction. It is more common to hire an independent firm to arrange and carry out the transaction or, also, to set up a special committee within the target company that will focus on the transaction (in coordination with management).

### 10. How are the equity arrangements typically regulated in a buyout?

Equity arrangements in a buyout are typically regulated by a shareholders agreement entered into by, and among, the Acquisition Company (SPV) and the remaining shareholders of the target company. Shareholders agreements are enforceable between the parties to them and, if a copy of the agreement is provided to the company, against the company (although, usually the target company intervenes in the shareholders agreement and acknowledges the enforceability of the provisions in it). Certain terms set out in the shareholders agreement, most commonly conditions regarding quorum and majority requirements for the adoption of certain agreements in relation to key aspects of the company, can be reflected in the company's bylaws.



## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

The company's bylaws may contemplate the existence of different classes of shares. The most common difference stipulated in relation to equity is between shares with voting rights and shares without voting rights. Under Corporations Law, shares without voting rights have preferential economic rights (i.e., a preferential right to participate in the distribution of dividends and reimbursement on liquidation). The company's bylaws may also establish particular differences among the different classes of shares, such as the possibility to vote in relation to certain aspects of the company or not, the right to elect a determined number of members of the board and different economic benefits.

It is also common to include in the shareholders agreement negotiated on the acquisition of the target company certain provisions in relation to the transfer of shares of the company by which the private equity funds have certain rights, such as tag or drag along rights, a right of first offer or a right of first refusal and put/call rights. It is not necessary to establish these differential rights by creating different classes of shares, but it is possible to do so.

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

### Board constituency

Under Peruvian corporate law, the board of directors must be comprised of at least three members that are elected by the shareholders' meeting for a minimum period of one year and a maximum period of three years. Shareholders can agree to appoint as many directors to the board as they wish (i.e., there is no maximum number) but a board must be comprised of a minimum of three directors. This applies to both private and public companies. Certain industries may require a higher minimum number of directors.

Peruvian corporate law has established an accumulative vote mechanism to guarantee that the minority shareholders of a company have representation on its board of directors, by which each share gives as many votes as the number of members of the board that will be elected (shareholders may accumulate their votes in one candidate or in several candidates), and the candidates that end up with more votes will be elected as directors of the company.<sup>30</sup> The bylaws of the company may establish that certain classes of shares have the right to elect a certain number of directors that may differ from the number of directors other classes of shares are entitled to elect. Shareholders may establish in a shareholders agreement a particular arrangement in relation to the election of directors. It should be noted that Peruvian corporate law does not contemplate the possibility of setting staggered boards (i.e., when only a fraction of the board of directors is elected per election instead of *en masse*, where all directors have one-year terms).

### Differential director voting rights

Differential director voting rights may be established either by different classes of shares in the bylaws or by particular agreements among shareholders by means of a shareholders agreement. In a shareholders agreement, the parties may establish different rules in relation to the election of directors (i.e., the numbers of directors to be elected by each shareholder or a group of shareholders).

---

<sup>30</sup> For example, if five directors are to be elected, each share will have five votes in the election of the board members.

## Removal of directors

Directors may be removed by the shareholders at a shareholders' meeting. The bylaws or the shareholders agreement may contemplate particular provisions in relation to the quorum and the majorities needed to remove a director.

### 13. What measures are commonly used to give a private equity fund some level of control over key operating and financial decisions made by a portfolio company?

The most common measure used by private equity funds to ensure a proper level of control is to negotiate a favorable shareholders agreement. In the shareholders agreement, it is common to include provisions in relation to quorum and majority requirements for the adoption of certain agreements by the board and the shareholders' meeting in relation to key aspects of the portfolio company, such as:

- (a) the approval of the business plan and annual budget;
- (b) the appointment of the chief executive officer, chief financial officer and other officers;
- (c) the approval of additional procurement funding;
- (d) the approval of equity issues; and
- (e) the approval of related party transactions rules.

Certain provisions regulated in the shareholders agreement can be reflected in the company's bylaws (most commonly, quorum and majority requirements provisions). Private equity funds will ensure that they have a majority on the portfolio company's board. It is also possible for the private equity fund to hold a class of shares with veto rights.

### 14. What employment terms are generally imposed on management in a buyout?

Management personnel have certain rights on dismissal under Peruvian Labor Law. Also, it is common to set specific bonuses for management that are awarded if the sale of the shares to the private equity fund is successful, including special bonuses if the sale price obtained for the shares exceeds a certain threshold. It is also common to make key officers sign an agreement by which they covenant to stay at the company for a certain minimum period of time (although this type of agreement is difficult to enforce in practice), as well as a non-compete agreement (usually, for a term between two and four years).

### 15. What equity incentives can be offered to management and how are they typically structured?

Equity incentives to management are not very common due to tax and corporate issues. However, establishing phantom stock options for management is a possibility and it is usually linked to a determined period of time or to the achievement of certain specific accomplishments or goals reached by the company under their direction.

### 16. How are buyouts typically debt financed and secured?

Debt financing can vary depending on each transaction. However, usually buyouts are financed by debt provided by banks, financial institutions or mezzanine financiers. Typically, the special purpose company incorporated for the particular acquisition by the private equity fund or a holding company controlled by the private equity fund is the recipient of the loan from the lenders. Sometimes, layering is implemented in the structure to allow structural subordination between lenders.



Securities for a loan usually varies between the granting of:

- (a) a security interest over the shares of the target company; or
- (b) a guarantee trust over the shares of the target company, which can be structured together with a management and guarantee trust over certain key assets of the company.

It is also common practice to establish mortgages over property of the target company or charges and encumbrances over assets of the target company.

Care should be taken with the financial assistance prohibition regulations discussed in more detail below in question 17.

## **17. Are there financial assistance issues to consider when undertaking a buyout?**

Corporations Law generally prohibits companies from providing financial assistance in connection with the acquisition of its own shares. In particular, Article 106 of the Corporations Law prohibits a company from:

- (a) granting loans, providing collateral or a guarantee for the acquisition of its own shares; or
- (b) providing or receiving collateral where that collateral consists of the company's own shares.

These prohibitions, however, do not extend to the shares of that company's parent company (either direct or ultimate).

## **18. What are the implications under the corporate benefit laws of Peru for a company providing financial assistance?**

Article 106 of the Corporations Law provides that a company's board members are liable for decisions that are considered financial assistance under Peruvian law.

Peruvian law requires that all corporate actions must benefit a company. Peruvian law also requires directors to act with the diligence of an orderly business person and loyal representative of the company. In particular, Article 177 of the Corporations Law provides that directors are jointly liable for damages and losses caused to the company, shareholders and third parties, through their actions when performed against the law or bylaws of the company or otherwise involve willful misconduct, abuse of authority or gross negligence.

In the case of financial assistance, the facts and circumstances of each transaction must be thoroughly analyzed to ensure that board members will not become liable.

## **19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?**

Insolvency laws have established an order of priority in the event of the insolvency of a company. Secured debt (as long as the security has been granted before the company is declared insolvent) such as debt secured by mortgages, security interests or other similar securities ranks higher in the order of priority of payment than unsecured debt. After the company has paid all debts due to employees, alimony claims, secured debt and tax obligations, unsecured creditors will collect their amounts due.

Reimbursement to the shareholders of their equity contributions is subordinated to the payment of all debt, including unsecured debt. Shareholders receive back their equity investment in the company only if there is a positive balance in the company remaining after payment of all debt.

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

The general rules to be taken into account in Peru are set out as follows.

### Stamp duty/transfer taxes

There are no stamp duty/transfer taxes in Peru. As such, the transfer of shares is not subject to any specific Peruvian tax.

### Deductibility and financing costs/thin capitalization

As a general rule, interest paid on financing obtained by the target company either in Peru or abroad is deductible if that interest is necessary, reasonable and related to the borrower's taxable income-earning activities.

The interest rate paid on the loan must be at fair market value to be deductible for tax purposes. Interest paid exceeding the fair market value is not deductible.

In relation to loans between related parties, the deductibility of interest is subject to thin capitalization rules.

### Withholding tax

If a loan is granted by a domiciled entity, no withholding tax applies on interest paid by the borrower.

If a loan is granted by a foreign entity, withholding tax applies on interest paid by the borrower at a rate of 4.99%, if certain requirements are met. Otherwise the rate is 30%. The rate of 30% also applies in the case of loans granted to related parties.

### Value Added Tax

Peruvian VAT is applied at an 18% rate. No reduced rates apply. No VAT is levied on the sale of shares.

Interest on loans granted by banking or financial institutions, domiciled or not domiciled in Peru, are also not subject to VAT. Interest on loans granted by other type of entities, are however, subject to VAT.

### Income tax on disposal

A disposal of shares issued by a Peruvian company by a Peruvian investment fund (*fondo de inversión*) is taxable at a rate of either 5% or 28%<sup>31</sup>, depending on whether the fund's stakeholder is an individual or an entity, in both cases, domiciled in Peru.

Capital gain arising from the sale, exchange or other disposition of Peruvian shares by foreign funds is subject to Peruvian income tax at a rate of 5% provided the following two requirements are satisfied:

- (a) the shares are registered in the SPR; and
- (b) the shares are negotiated in a Peruvian centralized stock market.

In all other cases, capital gains are taxable at a rate of 30%.

In certain cases, the acquisition value has to be certified by the Peruvian Tax Administration through a form presented by the seller. This certification is not needed if the sale is made through the BVL.

---

<sup>31</sup> This is the tax rate in force in 2015; the tax rate will be amended to (a) 27% in 2017; and (b) 26% in 2019.



## Corporate reorganizations

It is important to note that the transfer of shares by means of a corporate reorganization (where all the parties involved are domiciled companies) is not subject to the Peruvian income tax law.

### 21. What forms of exit are available?

A trade sale or sale to another financial buyer are the most common exit mechanisms in Peru used by private equity funds. It is also common to see, in cases where the original shareholders of the target company have maintained an equity package after the buyout, the private equity fund sell its participation back to the former controlling shareholders of the target company. An IPO process is not common but is also a potential way of exit for private equity funds.

## Philippines

### 1. What structures do private equity funds typically use to manage their funds?

Private equity funds are typically formed as corporations in the Philippines, with investors holding shares. Under the corporate structure, the liability of investors is limited to the extent of their subscription to the corporation.

Other forms of structure (e.g., limited partnerships) are not typically used in the Philippines as business vehicles, including for setting up a private equity fund.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in the Philippines?

#### General

A private equity fund in the Philippines does not need to be licensed to conduct its business. It must however obtain a certificate of incorporation from the Philippine Securities and Exchange Commission (**SEC**) and other permits and licenses from the relevant government agencies that persons engaged in business in the Philippines in general are required to obtain. These permits and licenses include:

- (a) a certificate of registration from the Philippine Bureau of Internal Revenue (**BIR**);
- (b) a business permit from each city or municipality where the private equity fund has a place of business; and
- (c) registrations as an employer with certain government agencies.

#### Registration as an investment company or investment adviser

An exception would be if the shares in the private equity fund are to be beneficially owned by more than 25 persons, or if the private equity fund proposes to make a public offering of its shares. In these cases, the private equity fund would be considered an investment company under the Philippine Investment Company Act and would need to register as such with the SEC. The investment adviser of the investment company would also need to be registered as such with the SEC.

#### Registration for an offer of securities

Securities that are offered in the Philippines must be registered under the Philippine Securities Registration Code except in certain instances. The exemptions usually relied on by private equity funds are either private placement (a sale to fewer than 20 persons) or a sale to 'qualified buyers'.

The following are considered to be 'qualified buyers':

- (a) banks;
- (b) registered investment houses;
- (c) insurance companies;
- (d) pension funds or retirement plans maintained by the Government of the Philippines or any of its political subdivisions or managed by a bank or other persons authorized by the Bangko Sentral ng Pilipinas (**BSP**) to engage in trust functions;
- (e) investment companies; and



(f) other persons that the SEC may determine to be qualified buyers.

### 3. Are there any approvals required for investments by foreigners in the Philippines and, if so, what is the process?

#### Foreign investment restrictions

As a general rule, foreign investors may own up to 100% of a domestic enterprise in the Philippines provided that the domestic enterprise is not engaged in any of the activities listed in the Negative Lists of the Foreign Investments Act, as amended. There are two Negative Lists: List A and List B.

List A contains areas of investment where foreign ownership is limited by mandate of the Philippine constitution and/or by specific laws. List B contains areas of investment where foreign ownership is limited for reasons of security, defense, risk to health and morals, or protection of local small and medium-size enterprises. List B cannot be amended more than once every two years.

Under the Foreign Investments Act, as a general rule, a domestic market enterprise (i.e., which produces goods for sale, or renders services or otherwise engages in any business in the Philippines) that is more than 40% foreign-owned must have paid-in or assigned capital of the Philippine Peso equivalent of at least USD 200,000. That minimum capitalization requirement of USD 200,000 may be reduced to USD 100,000 if the activity involves advanced technology as certified by the Department of Science and Technology, or if it employs at least 50 direct employees as certified by the appropriate regional office of the Department of Labor and Employment (DOLE). Export enterprises (i.e., manufacturers, processors or service entities exporting 60% or more of their output, or traders purchasing products domestically and exporting 60% or more of those purchases) need not comply with this minimum capitalization requirement.

#### Anti-dummy law

The Philippines has an Anti-Dummy Law that imposes criminal and civil penalties on those violating nationalization laws. The Anti-Dummy Law prohibits foreign nationals from, among other things, intervening in the management, operation, administration or control of a company engaged in a nationalized or partially nationalized activity, whether as officer or employee (excluding technical personnel specifically authorized by the Secretary of Justice). However, foreign nationals may serve as members of the board or governing body of corporations engaged in partially nationalized activities in a number proportionate to their actual and allowable equity in the company.

#### Foreign investment registrations for foreign exchange purposes

A foreign investor has the option of registering its investments with the BSP. Registration allows the foreign investor to purchase foreign exchange from authorized agent banks and other entities regulated by the BSP for purposes of repatriation of capital and remittance of dividends. However, even without such registration of the investment with the BSP, the foreign investor can still purchase foreign exchange from persons other than authorized agent banks and other entities regulated by the BSP.

### 4. Who are the relevant regulators in the Philippines and how much interaction would one generally expect when undertaking a buyout?

The following are the primary regulatory authorities in the Philippines in a corporate context:

- (a) Philippine Securities and Exchange Commission (**SEC**) - issues the primary license of, and exercises supervision over, corporations, administers the laws regulating foreign investments and capital markets and exercises regulatory authority over the Philippine Stock Exchange and capital market participants;

- (b) Philippine Stock Exchange (**PSE**) - a private self-regulatory organization and is currently the only stock exchange in the Philippines;
- (c) Department of Justice - functions as the Competition Authority in the Philippines so it has jurisdiction over competition issues arising from acquisitions;
- (d) Bangko Sentral ng Pilipinas (**BSP**) - the central monetary authority of the Philippines; and
- (e) Philippine Bureau of Internal Revenue (**BIR**) - the national taxation authority.

## 5. How are buyouts typically undertaken in the private and the public markets?

### Private companies

For private companies, a buyout is generally undertaken by way of a private acquisition. The parties execute a sale and purchase agreement, which sets out the terms and conditions of the acquisition.

### Public companies

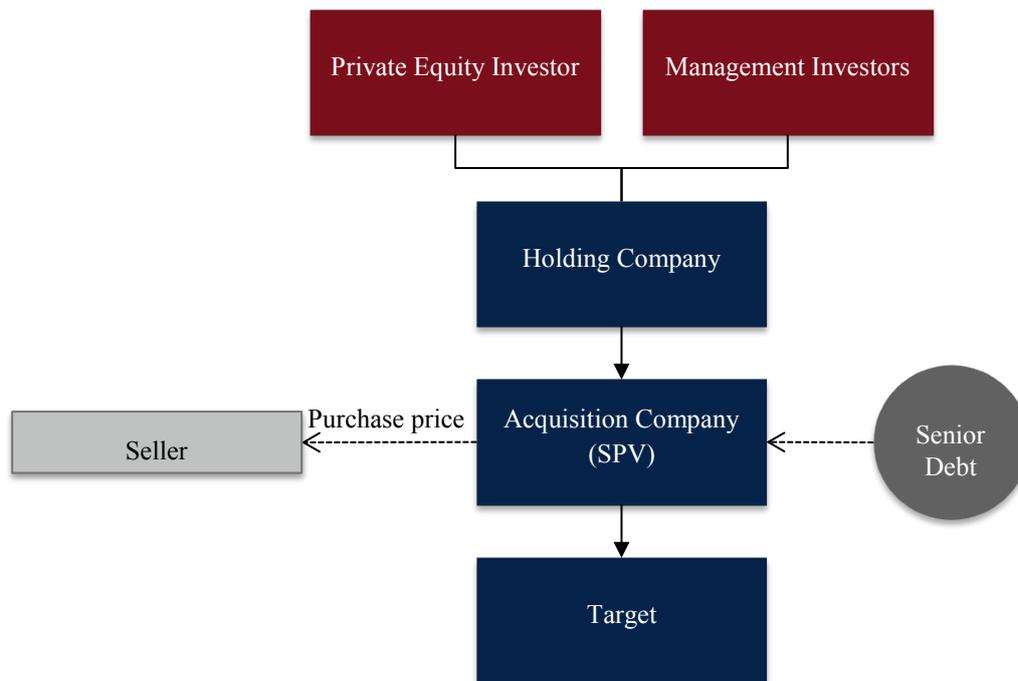
For public companies, a proposed buyout may trigger the mandatory offer rule. Under Philippine law, a tender offer is required in the following instances:

- (a) when a person or a group of persons acting in concert intends to acquire at least 35% or more of the shares of a public company in a 12-month period; or
- (b) any acquisition (even if less than 35%) that would result in ownership of over 51% of the total outstanding shares of a public company. The buyout of a public company pursuant to a private transaction cannot be completed prior to the completion of the tender offer, and must close on the same terms as the tender offer made to the public.

Although sale through auction is not yet common in the Philippine market, a handful of recent transactions involving the sale of certain businesses of multi-national companies have been undertaken through this process.



## 6. What is the typical corporate structure used when doing a buyout?



Funds may undertake a buyout of a company directly or through a holding company and/or special purpose acquisition vehicle (Acquisition Company SPV) organized as a corporation under Philippine law (note that although there is no separate concept of a limited liability company under Philippine law, a corporation organized under Philippine law is similar to a limited liability company, as a shareholder is liable for the liabilities of the company only to the extent of his unpaid subscription). The Acquisition Company SPV is usually a private company, not a public company.

The choice of the corporate structure may be tax-driven. From a Philippine tax perspective, there is no difference in taxation between a direct acquisition and an acquisition through a holding company. However, depending on the tax regime in the jurisdiction of incorporation of the purchaser, there could be tax benefits for the purchaser if the acquisition is effected through a holding company established in a jurisdiction that has an existing tax treaty with the Philippines.

## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

Typically, the investor and the seller/target company initially sign a confidentiality agreement.

Negotiation usually begins with the signing of a term sheet, which is a summary of basic points agreed, or to be agreed, between the investor and the seller/target company. After the due diligence in relation to the target company is completed, the share purchase agreement, subscription agreement or investment agreement is executed by the investor and the seller/target company.

Typically, a shareholders agreement is also entered into among the investor, the target company, incoming management and the existing shareholders of the target company if the investor does not acquire all the shares in the target company. If a holding company/Acquisition Company is set up to hold all of the shares in the target company (and the investor will hold shares in the Acquisition Company instead of directly in the target company), the shareholders agreement includes provisions in relation to the setting up of the Acquisition Company, the issue of shares in the Acquisition

Company to the investor, and provisions relating to the operation and management of both the Acquisition Company and the target company.

The provisions of the shareholders agreement pertaining to matters that are covered by the respective articles of incorporation or bylaws of the Acquisition Company and the target company will be incorporated in the bylaws themselves. Other documents may need to be executed when undertaking a buyout, such as employment agreements with key employees, an employee share option plan, and other ancillary agreements.

## Banking

The main loan document is the facilities agreement under which the terms of the loan made to the target company are documented. Security documents are also executed under which the target company provides security for the loan. The nature of the security depends on the operations/assets of the target company, and can include mortgages (real property mortgage and/or chattel mortgage) and pledges.

If there are different lenders, their relative positions depend on subordination and other contractual arrangements negotiated between the parties.

### 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

A private equity fund can require a full range of warranties and indemnities from the sellers and management as a form of buyer protection when undertaking a buyout, as well as specify conditions precedent to the closing of the acquisition. Part of the purchase price may also be withheld or placed in escrow for a fixed period to meet any warranty or indemnity claim.

It is not typical in the Philippines for the seller to provide warranty & indemnity insurance. To our knowledge, this type of insurance is not yet available in the Philippines.

### 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

There are no specific laws regulating how conflicts of interest should be managed in a typical management buyout. However, the Corporation Code of the Philippines (**Corporation Code**) imposes on directors duties of diligence and loyalty to the company. The duty of diligence means that a director must act with good faith and with due care in directing the affairs of the company. The duty of loyalty means that a director must not acquire any personal or pecuniary interest in conflict with his or her duty as a director. To our knowledge, management protocol letters are not typically used in the Philippines.

Directors may also be subject to personal liability if they have a conflict of interest that results in damage to the company or its shareholders. If they acquire any interest adverse to the company in relation to any confidential matter and in respect of which it would be inequitable for them to act on their own behalf, they could be liable as a trustee for the company and must account for the profits which otherwise would have accrued to the company.

For a listed company, transactions between the company and a director or key officer must also be disclosed to the SEC and the PSE and, in certain instances, must be approved by the shareholders. The disclosure is uploaded onto the PSE's website and may be accessed by the public.



## 10. How are the equity arrangements typically regulated in a buyout?

The equity arrangements in a typical buyout are regulated primarily by the target company's/Acquisition Company's articles of incorporation and bylaws, which set out:

- (a) the classes of shares that the target company/Acquisition Company can issue and the respective features of the classes of shares; and
- (b) special voting requirements for certain corporate acts.

The articles of incorporation and bylaws can be amended to incorporate the equity arrangements agreed on by the investor and the target company /existing shareholders. The amendment requires the approval of the target company's board of directors and shareholders and approval by the SEC.

The investor and the existing shareholders also execute a shareholders agreement setting out rights such as the right of first refusal, drag-along rights, and tag-along rights at the level of the target company/Acquisition Company.

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

Philippine law allows a company to have different classes of shares with different rights and features. Typically, the classes of shares include common shares, preferred shares and redeemable shares. There are however restrictions in relation to the issue and redemption of redeemable shares.

Certain classes of shares can have different voting rights and can also be excluded from voting in relation to certain matters except the following fundamental corporate matters:

- (a) amendment to the articles of incorporation;
- (b) adoption and amendment of the bylaws;
- (c) sale, lease, exchange, mortgage, pledge or other disposition of all, or substantially all, of the corporate property;
- (d) incurring, creating or increasing bondedness;
- (e) an increase or decrease of capital stock;
- (f) merger or consolidation of the corporation with another corporation or other corporations;
- (g) an investment of corporate funds in another corporation or business; and
- (h) dissolution of the corporation.

The level of 'rights tailoring' is limited if the target company is engaged in a business or industry sector that is subject to foreign equity restrictions (as set out in the answer to question 3). In that case, a foreign entity cannot intervene in the management, control, operation or administration of the target company except to the extent of its representation to the target company's board of directors (the representation on which is proportionate to the foreign entity's allowable shareholding), and the rights granted to the different classes of shares cannot contravene this prohibition.

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

In general, the board of directors of a corporation exercises all corporate powers, conducts all the business, and controls all the property of the corporation.

A corporation must have at least five but no more than 15 directors, each of whom must have at least one share registered in his or her name. Foreign individuals may sit on the board of directors of a corporation. A majority of the board must be residents of the Philippines. Under the law, the vote of shareholders representing 2/3 of the outstanding capital stock is required to remove a director.

Each director has one vote. The bylaws of a corporation cannot provide for directors to have different voting rights. However, as discussed above, a class of shares may be denied voting rights, except if, in the case of a corporation that is engaged in a partially-nationalized activity, the denial of voting rights would have the effect of giving the foreign investor voting rights in excess of what is proportionate to its allowed equity in the company.

Except for classes of shares that do not have voting rights, shareholders are entitled to one vote per share, including in relation to the election of directors. Therefore, a shareholder's representation on the board of directors would typically be proportionate to its shareholding. However, except in the case of a foreign investor acquiring shares in a corporation engaged in a partially-nationalized activity, the shareholders' agreement may provide that the investor's representation on the board can be greater than representation that is proportionate to its shareholding. This type of arrangement would require the other shareholders to vote in respect of their shares in favor of the election of the nominee/s of the investor (and not by giving the shares held by the investor more voting rights than those held by the other shareholders, which is not allowed under the law). In cases of companies where the allowed foreign equity is limited to a certain percentage, a foreign shareholder can be represented on the company's board of directors only in proportion to the foreign shareholder's allowed foreign equity.

### 13. What measures are commonly used to give a private equity fund some level of control over key operating and financial decisions made by a portfolio company?

The fund can have representation on the board of the Acquisition Company, as well as on the board of the operating companies, in proportion to its shareholding. Representation on the board may also include membership on the executive committee and any other board committees.

The shareholders agreement can also create particular corporate governance and approval authority workflows to impose restrictions on the management in undertaking certain matters without board approval. To enable the fund to monitor the portfolio company's performance, the shareholders agreement may also include provisions requiring the company:

- (a) to provide the fund with certain financial and operating information; and
- (b) to give the fund and its advisors regular access to the books and accounts of the corporation.

The Corporations Law also requires that shareholders' approval be obtained in relation to, *inter alia*, the following matters:

- (a) adoption and amendment of the articles of incorporation/bylaws;
- (b) removal of directors;
- (c) ratification of a contract of a director or officer;
- (d) extension or shortening of a corporate term;
- (e) the increase or decrease of the capital stock;
- (f) incurring, creating or increasing bonded indebtedness;



- (g) sale, lease, exchange, mortgage, pledge or other disposition of all or substantially all of the corporate assets;
- (h) investment of corporate funds in another corporation or business or for any purpose other than the primary purpose;
- (i) declaration of stock dividends (the approval of the stockholders is not required with respect to other dividends such as cash and bond dividends);
- (j) entering into management contracts, in some cases;
- (k) delegation to the board of directors of the power to amend or repeal the bylaws or adopt new bylaws;
- (l) effecting or amending of a plan of merger or consolidation;
- (m) dissolution of the issuer;
- (n) calling a special meeting to remove directors;
- (o) entering into management contracts; and
- (p) fixing of the issued price of no par value shares, if the board of directors is not authorized by the articles of incorporation to do so.

The matters listed in paragraphs (a) to (m) require the affirmative vote of shareholders representing at least 2/3 of the outstanding capital stock for their approval, while the matters listed in paragraphs (n) to (p) require the affirmative vote of shareholders representing a mere majority of the outstanding capital stock. The bylaws of a corporation may provide a higher voting requirement.

Further, the records of all business transactions of the corporation and the minutes of any board or shareholders' meeting must be open for inspection by any shareholder or director at reasonable hours on business days, and he or she may demand, in writing, a copy of excerpts from the records or minutes, at his or her expense.

#### **14. What employment terms are generally imposed on management in a buyout?**

Long-term agreements are often entered into with key personnel of the target company to ensure continuity. Key employment terms include non-compete clauses and confidentiality clauses. Incentive plans tied to the company's performance may also be adopted to provide incentives to management and to ensure long-term retention of management.

#### **15. What equity incentives can be offered to management and how are they typically structured?**

##### **Private companies**

Generally, incentive plans for management are structured on a long-term basis, although short-term incentives based on annual results may also be provided. If the fund decides to take the company public, stock options (with or without lock-ups) may also be a typical incentive available. The incentives may be in the form of, among other things, a stock purchase plan (which allows management to purchase shares at a discount), performance options (which are granted and vest in annual tranches), and restricted stock units (which vest after a certain number of years).

In relation to the difference in the treatment between 'good leavers' and 'bad leavers', this is embedded in the structure of the vesting period in stock options.

To our knowledge, ratchet mechanisms are not used in the Philippines.

## Listed companies

In the case of a listed company, there are restrictions in the ability of the listed company to issue shares to its management (or to any other related party, as defined in the PSE listing rules) if the shares to be issued amount to at least 10% of the total issued stock of the listed company through a single transaction or creeping transactions within a 12-month period. Under the PSE listing rules, a listed company is required to undertake a rights offering if it intends to issue shares to its management. A rights offering need not be undertaken if the listed company obtains either:

- (a) stockholders' approval for the issue of shares; or
- (b) a waiver of the requirement to conduct a rights offering, granted by a majority vote representing the outstanding shares held by the minority stockholders present or represented in the meeting during which the shareholders approved the issue of the shares.

If a waiver of the requirement to conduct a rights offering is obtained, the shares that are issued to management cannot be sold, assigned or in any manner disposed of for a minimum period of 180 days from the listing of those shares. Even without a waiver being obtained, the PSE will grant an exception to the rights offering requirement in certain cases, including where the shares issued to management will eventually be offered in a subsequent follow-on public offering.

## Taxation

In terms of taxation, as a general rule, the spread or income derived from management's receipt of stock-based incentives is treated as a fringe benefit subject to fringe benefits tax (**FBT**). The FBT is paid by the employer and is based on the grossed-up monetary value of the benefit at the rate of 32%.

### 16. How are buyouts typically debt financed and secured?

The structure of debt financing varies from transaction to transaction. The most common structure includes senior debt provided by a bank and mezzanine debt.

The nature of the security depends on the operations/assets of the target and can include mortgages (real property mortgage and/or chattel mortgage) and pledges. The relative priority of security would depend on the contractual arrangements negotiated between the parties.

### 17. Are there financial assistance issues to consider when undertaking a buyout?

There is no statutory restriction in the Philippines on a corporation providing financial assistance<sup>32</sup> in connection with the acquisition of its own shares or those of its parent corporation.

A corporation can exercise powers that are:

- (a) expressly allowed under the Corporation Code;
- (b) authorized in the purpose clause of its articles of incorporation; and

---

<sup>32</sup> 'Financial assistance' means for the purposes of this review financial assistance in connection with an acquisition given by a company which has been acquired or whose parent company has been acquired by way of:

- (a) guarantee or indemnity in respect of the obligations of the acquirer;
- (b) grant of security to support the obligations of the acquirer;
- (c) loans or transfer of assets to the acquirer; or
- (d) dividend or other distribution to the acquirer following the acquisition.



- (c) incidental to its existence, or implied or necessary to carry out the purposes as stated in its articles of incorporation.

Therefore, unless the articles of incorporation contains an express restriction from doing so, a Philippine corporation may provide financial assistance in connection with the acquisition of shares in itself or its parent corporation, if:

- (a) the giving of the financial assistance is reasonably justified to be furthering the Philippine corporation's primary purpose(s); and
- (b) the applicable approvals are obtained.

The requirements and considerations that need to be taken into account when a company is deciding whether to give financial assistance are set out below.

### **Incur, create or increase bonded indebtedness**

Under the Corporation Code, no corporation may incur, create or increase any bonded indebtedness unless approved by a majority vote of the board of directors and by the shareholders representing at least two-thirds of the outstanding capital stock. The SEC has ruled that the term 'bonded indebtedness' refers to bonds that are secured by corporate property, as distinguished from 'debentures,' which are unsecured corporate indebtedness.

### **Sell, dispose of, lease or encumber assets**

Under the Corporation Code, a corporation, when authorized by a majority vote of the board of directors and by the shareholders representing at least two-thirds of the outstanding capital stock, may sell, lease, exchange, mortgage, pledge or otherwise dispose of all or substantially all of its property or assets. The test for determining whether the transaction involves 'substantially all' of the corporate assets or property is whether the sale or disposition of the relevant corporate property or assets will render the corporation incapable of accomplishing its corporate purposes.

### **Corporate funds in another corporation or business**

Under the Corporation Code, a corporation may invest its funds in another corporation or business or for any other purpose other than the primary purpose as stated in its articles of incorporation when approved by a majority of the board of directors and ratified by the stockholders representing at least two-thirds of the outstanding capital stock.

### **Guarantee**

So that a Philippine company may guarantee the performance of the obligations of another firm, entity or person, the articles of incorporation of that Philippine corporation should expressly include, as one of its secondary purposes, that it is authorized to guarantee the performance of any undertaking or obligation of other firms, entities or persons.

### **Third party mortgage or pledge**

The SEC has ruled that if a corporation wishes to authorize the mortgage or pledge of its corporate assets as security for the obligations of another firm, entity or person it must comply with the following conditions:

- (a) there is no express restriction in the articles of incorporation or bylaws;
- (b) the purpose of the mortgage or pledge is not illegal;
- (c) written or formal consent of corporate creditors and stockholders must be secured;

- (d) the transaction is not used as a scheme to defraud or prejudice creditors or result in the infringement of the trust fund doctrine; and
- (e) the mortgage will not hamper the continuous business operations of the mortgagor corporation, and the accommodated third party involved is financially solvent and capable of paying the creditor.

## Dividends

A corporation can only distribute dividends to stockholders. The board of directors of a Philippine stock corporation can declare dividends out of unrestricted retained earnings, which may be payable in cash, property or stock. A corporation may not issue dividends in the form of stock without the approval of stockholders representing at least two-thirds of the outstanding capital stock.

## 18. What are the implications under the corporate benefit laws of the Philippines for a company providing financial assistance?

### Directors' duty of diligence

The Philippine Supreme Court has held that the primary obligation of the directors of a corporation is 'to seek the maximum amount of profits for the corporation,' and characterized a director's position as a 'position of trust'. This fiduciary relationship is not a matter of statutory law, but springs from the fact that directors have control and guidance of corporate affairs and property and therefore of the property interest of the stockholders.

In line with the directors' fiduciary duty, the Corporation Code provides that directors, who willfully and knowingly vote for or assent to patently unlawful acts of the corporation or who are guilty of gross negligence or bad faith in directing the affairs of the corporation, are jointly and severally liable for all damages suffered by the corporation, its shareholders and other persons as a result of those acts by those directors. At risk of being made personally liable for damages suffered by the corporation, its shareholders and other persons, directors are mandated by this provision to observe a duty of diligence in connection with the corporation providing financial assistance.

### Corporate rehabilitation scenario

Under the Financial Rehabilitation and Insolvency Act of 2010 (**FRIA**), 'corporate rehabilitation' is defined to refer to the restoration of the corporate debtor to a condition of successful operation and solvency, if it is shown that its continuance of operation is economically feasible and its creditors can recover more by way of the present value of payments projected in the rehabilitation plan if the debtor continues as a going concern than if it is immediately liquidated.

If the Philippine corporation providing the financial assistance becomes the subject of corporate rehabilitation, the corporate benefit received by the Philippine corporation in connection with providing the financial assistance may have an impact on the rehabilitation court's determination of the terms of repayment or enforcement of obligations incurred by the Philippine corporation in connection with providing the financial assistance.

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

There are rules on preference of claims that apply where two or more creditors have separate and distinct claims against the same debtor who has insufficient property to pay its debts in full. Secured creditors take priority over unsecured creditors in relation to the property over which security has been created. With respect to other property of the debtor to which no specific liens attach, the law provides for the preference of certain claims and credits.



## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

The fund must consider the tax implications at every stage of the buyout as set out below.

### Transfer of shares

Under existing laws and regulations, the transfer of shares of stock in a Philippine corporation generally qualifies as a taxable event. In particular, the transfer of shares will attract transaction tax, capital gains tax (CGT), documentary stamp tax (DST), and in some cases, donor's tax.

#### *Transaction tax/DST*

The acquisition of shares in a listed company is subject to a stock transaction tax of 0.5% of the gross selling price of the shares. This tax applies only if the acquisition is done using the facilities of the PSE.

The acquisition of shares in a listed company that is not done using the facilities of the PSE, and the acquisition of shares in a non-listed company is subject to the following taxes:

- (a) DST of PHP 0.75 for every PHP 200 or fraction thereof (effectively 0.375%) of the total par value of the shares to be transferred. The DST is payable by either party to the transaction (depending on their agreement). Note that there is no exemption from the DST on the transfer of shares, even if the seller is a non-resident. However, share transfers pursuant to a 'tax-free' merger or exchange are exempt, provided the requirements of the tax legislation are met; and
- (b) donor's tax of 30%, if the fair market value of the transferred shares exceeds the purchase price (the excess is considered to be a 'gift' subject to donor's tax, with the donor's tax levied on the excess).

#### *Capital gains tax*

For sales or transfers of shares in a Philippine corporation, the net capital gains derived by a non-resident foreign corporation are subject to capital gains tax at a rate of 5% of the net capital gains not exceeding PHP 100,000 and 10% of net capital gains in excess of the first PHP 100,000.

Provided the conditions of an applicable tax treaty are met, a non-resident foreign corporation which transfers shares in a Philippine corporation may be able to claim exemption from CGT. To confirm the exemption, the non-resident foreign corporation must file a tax treaty relief application (TTRA) with the Bureau of Internal Revenue and obtain an official ruling.

### Dividends

Dividends paid to a domestic corporation or a resident foreign corporation are not subject to dividend tax, whereas dividends paid to a non-resident foreign corporation are generally subject to a final withholding tax of 30%. A lower rate of 15% may apply, subject to the condition that the country in which the non-resident foreign corporation is domiciled allows a credit against the tax due from the non-resident foreign corporation (taxes deemed to have been paid in the Philippines equivalent to 15%, which represents the difference between the regular income tax of 30% and the 15% tax on dividends). Philippine tax treaties may also provide for a lower tax rate on dividends.

### Tax treaties

The Philippines has tax treaties with many countries to avoid double taxation of income earned in one country by a resident of another country. There is also reduction or exemption of tax on certain types of income, such as dividends, capital gains and business profits provided in the tax treaties.

## Thin capitalization

The Philippines has no legislated thin capitalization rules. However, the thin capitalization of a company may prompt the Philippine Bureau of Internal Revenue (BIR) to investigate whether there may be basis to assess deficiency taxes and penalties, particularly if the debts of the company are primarily related party loans and are not arm's length. Under Philippine law, the BIR is authorized to allocate income and expenses between related companies to ensure that the income of these companies is reported correctly and the appropriate tax is collected from them. In determining whether a financing/loan is a bona fide loan or disguised dividends, the BIR may look at a number of factors including, but not limited to the:

- (a) right of the lender to enforce payment of principal or interest;
- (b) presence or absence of a fixed maturity date;
- (c) ability of the company to obtain loans from outside lending institutions; and
- (d) status of the contribution in relation to the Philippine regular creditors.

## 21. What forms of exit are available?

In solvent situations, the common forms of exit are via initial public offerings or trade sales to strategic investors or to another private equity firm. We have seen only a couple of secondary buyouts in the Philippines, and are not aware of any leveraged recapitalization.

In insolvent situations, the company may still be sold to another private equity firm or a strategic investor if the buyer feels it can derive better value from the insolvent company. In terms of a 'rescue' scheme, if the requisite conditions are present, the company may commence voluntary insolvency proceedings. They could either be rehabilitation proceedings (i.e., with the intention of bringing back the company to a solvent status) or liquidation proceedings (i.e., with a view to dissolving the company and returning capital to the shareholders after the creditors have been paid).

The commencement of voluntary rehabilitation proceedings requires approval by a majority of the board of directors (unless a higher vote requirement is specified in the company's articles of incorporation and bylaws), and stockholders representing at least 2/3 of the outstanding capital stock (unless a higher vote requirement is specified in the company's articles of incorporation and bylaws). On the other hand, for voluntary liquidation proceedings, a verified petition for liquidation must be filed in court, establishing the insolvency of the company.



## Poland

### 1. What structures do private equity funds typically use to manage their funds?

Most private equity funds doing business in Poland are established abroad, with Luxembourg or Dutch holding company structures being the most commonly used investment vehicles for an LBO acquisition.

The following two structures are commonly used by Polish private equity funds to manage funds generated through their investor base:

- (a) Investment funds organized in accordance with the Polish Investment Fund Act (**IFA**) and an investment fund company which is the entity which manages investment funds created for the purpose of specified deals; or
- (b) limited partnership structure whereby investors hold limited partnership interests in the partnership and there is a general partner that takes control of day-to-day management of the partnership and its operations or a limited liability company (**LLC**) structure whereby the investors hold shares in an LLC. Commonly, a special company is created which manages all investments relating to the funds.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in Poland?

If the private equity fund is organized as a limited partnership structure, there are no regulations imposing special requirements for a private equity fund in Poland.

In the case of an investment fund company structure, the investment fund company and each fund needs to be licensed and registered with the Financial Supervisory Commission (**KNF**) under the IFA. Note that all appointments to the management board of an investment fund company must also be notified to the KNF.

### 3. Are there any approvals required for investments by foreigners in Poland and, if so, what is the process?

#### Foreign investment restrictions

Poland does not, in general, restrict the entry and establishment of businesses by foreigners. There are, however, some authorization requirements and foreign equity limits for some sensitive industry sectors (e.g., broadcasting and air transport) and the acquisition of real estate in Poland. There are also restrictions in relation to investments in sensitive areas for domestic and foreign investors alike (e.g., investments in the banking or media sector).

#### *Requirements for foreign ownership of real estate*

The purchase of real estate (or the acquisition of shares in a company owning real estate) in Poland by a 'foreign person' requires a permit from the Minister of Internal Affairs and Administration. 'Foreign person' includes:

- (a) a natural person who is not a Polish citizen;
- (b) a legal entity incorporated outside Poland;
- (c) a partnership of persons described above having its seat outside Poland and incorporated outside Poland; and

- (d) a legal person or partnership without legal personality incorporated in Poland, which is, directly or indirectly, controlled by persons or partnerships described above.

A permit is also required if a foreign investor acquires shares in a foreign-controlled Polish company in which the foreign investor is not already a shareholder and the company owns real estate in Poland.

#### *Exceptions*

There are exceptions to these requirements as follows:

- (a) a permit is not required in certain special cases set out in the Act on Acquisition of Real Estate by Foreigners (e.g., in relation to a purchase of shares in a publicly listed company which owns real estate in Poland, or in relation to a purchase of a flat by a foreign person); and
- (b) Poland's accession to the European Union has made investing in Poland significantly easier. Citizens and business entities from the EEA are not required to obtain a permit for the acquisition of real estate or in relation to the acquisition of shares in companies that own real estate in Poland. Note however, that acquisitions of agricultural and forest land by EU-based investors will continue to be subject to permit requirements until May 2016.

Notwithstanding these restrictions, investment by foreign entities in real property in Poland is a reasonably simple process. In practice, approval is rarely refused in the case of the acquisition of real estate or companies owning real estate.

#### Exchange controls

Foreign exchange transactions between Polish residents and non-residents who are residents of the EU, the EEA or OECD countries (**Member Countries**) are generally free from limitations on exchange control, subject to a few minor limitations, including the obligation to transfer funds via a bank account if the amount of the transfer exceeds the equivalent of EUR 15,000, a prohibition on payments in currencies defined as non-convertible currencies, and restrictions on exports and imports of gold and platinum.

State controls still exist in relation to countries other than the Member Countries, defined as 'third countries'. Transactions with persons registered, resident or otherwise located in these countries often require obtaining a permit from the National Bank of Poland. However, pursuant to a general permit issued in 2009 by the Polish Minister of Finance, countries which have concluded either bilateral investment treaties with the Republic of Poland or treaties with the EU which require Poland to lift the restriction on capital transfers with such countries (**BIT Countries**), enjoy similar, restriction-free treatment to the Member Countries.

The Foreign Exchange Act provides a list of foreign exchange transactions which, when carried out with an entity from a third country other than the Member Countries or the BIT Countries, may be performed only with a foreign exchange permit. Non-residents from third countries must obtain a permit to sell and/or buy in Poland securities or debts, except for securities or debts primarily acquired in Poland.

Other types of transactions which fall within the scope of the Foreign Exchange Act include:

- (a) transfers of funds by Polish residents to third countries for the development of business activity;
- (b) investments by Polish residents in third countries in real property, securities or purchase of debts, and
- (c) the opening of bank accounts in third countries by Polish residents.



Although transfers of funds from Poland are legal, residents conducting foreign exchange transactions are required to use a bank as an intermediary if the amount of the transaction exceeds EUR 15,000 or its equivalent. The banks have some supervisory obligations with respect to the transfer of funds involving foreign exchange transactions between residents and non-residents. There are no restrictions on the opening of bank accounts by non-residents.

#### 4. Who are the relevant regulators in Poland and how much interaction would one generally expect when undertaking a buyout?

The primary regulatory authorities in Poland in a corporate context are:

- (a) the National Court Register (**KRS**) – the registry court which constitutes the primary supervisor of corporate laws;
- (b) the Financial Supervisory Commission (**KNF**) – the primary regulator of financial, investment funds, banking and stock exchange law;
- (c) the Warsaw Stock Exchange (**GPW**) – the major stock exchange in Poland that provides additional regulation for GPW-listed entities;
- (d) the Office of Competition and Consumer Protection (**UOKiK**) – the competition/antitrust regulator;
- (e) the Taxation Authority; and
- (f) the Ministry of Internal Affairs (**MSWiA**) – dealing with foreign investment approvals regarding the acquisition of real estate in Poland.

The extent of KNF's and GPW's supervision in a buyout situation largely depends on whether the transaction is in relation to a publicly listed company. Generally, interaction between regulators is generally higher in cases concerning public deals than in the case of a transaction negotiated as a private acquisition.

Interaction with other authorities will depend on the nature of the transaction (e.g., whether the buyout takes place in the media or banking sector or whether it involves competition/antitrust issues) and the parties concerned.

#### 5. How are buyouts typically undertaken in the private and the public markets?

##### Private companies

Most acquisitions of private companies in Poland take place as privately negotiated deals and have tended to follow the Anglo-Saxon model (e.g., with a large number of representations and warranties, although legally, bearer shares in a joint-stock company may even be transferred by way of an oral agreement).

Customarily, parties to a private agreement would initially execute a long-form preliminary share purchase agreement in which the closing and actual transfer of shares or assets would be conditional on fulfilment of various conditions precedents (in particular the obtaining of all necessary regulatory approvals), followed by execution of the final share purchase agreement after the conditions have been fulfilled. In addition, the parties execute a short transfer agreement that effectively transfers the shares or the assets. Parties sometimes use escrow arrangements under which the purchase price is deposited with a bank or a broker at the signing of the long-form final share purchase agreement and released on closing and satisfaction of the conditions precedent.

A private agreement between a Polish and foreign party may be subject to foreign law provided that there is a link between the transaction and that governing law (e.g., it is the law of the country of the other party).

## Public companies

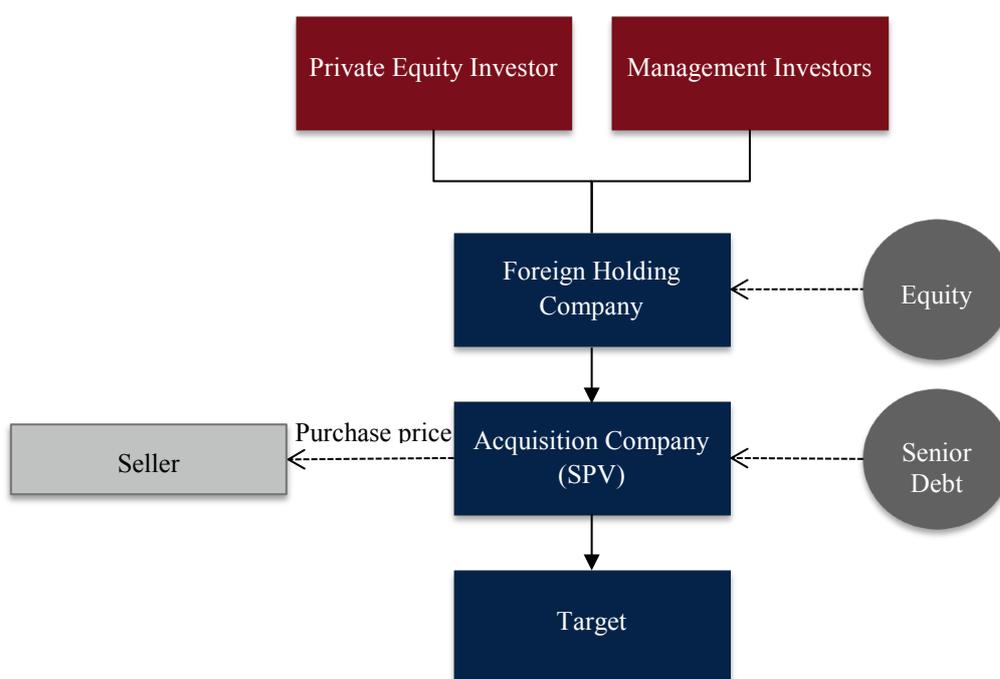
Generally, acquisitions of shares of a listed company comprising over 10% of the votes at the shareholders' meeting in one or a series of transactions (5% if the purchaser already controls more than 33% of the votes) is not possible other than by way of a tender offer for shares representing at least respectively 10% or 5% of votes at the shareholders' meeting. A purchaser may avoid this requirement by purchasing less than the relevant threshold of shares (9.99% or 5%, as the case may be) and waiting 60 days (or in the case of 5%, 12 months) to complete the next purchase.

Under Polish securities laws, any person who becomes the holder of shares of a listed company representing more than 33% of the votes at the shareholders' meeting must announce a tender offer to acquire at least 66% of the shares in the company. Further, any person who becomes the holder of shares representing more than 66% of the votes at the shareholders' meeting of a listed company must announce a tender offer to acquire all the remaining shares in the company. Generally, the tender offer obligation arises regardless of the method in which the acquirer crosses the thresholds. The tender price is also regulated and it cannot be lower, as the case may be, than the average market price over the period of the last three months or six months, or the price paid for the shares in a listed company by the purchaser or its affiliated entities over a period of 12 months preceding the tender offer.

Moreover, if any person or entities conclude an agreement for the joint acquisition of shares in a listed company or an agreement to vote in concert at the shareholders' meeting, they are jointly obliged to announce a tender offer as described above if the relevant thresholds (33% and 66%) are reached.

## 6. What is the typical corporate structure used when doing a buyout?

Although acquisition structures do vary from transaction to transaction, it is fairly common to see a two-level holding company structure adopted along the following lines:





The form and jurisdiction in which the entity investing in the Polish assets is located is crucial for the tax effectiveness of the structures. A key issue for non-resident investors is whether the relevant entity may benefit from a participation exemption on exit, and from treaty protection or protection under the EU tax directives implemented into Polish tax law.

Polish investment funds may be an interesting option particularly for resident investors, but more commonly EU holding vehicles are used for structuring private equity deals in Poland. The most popular jurisdictions are Luxembourg, Cyprus and the Netherlands. This type of structure allows for senior debt finance to be provided to the Acquisition Company (which is typically a newly formed special purpose vehicle), while the equity contribution from the private equity fund or funds is contributed at the holding company level and subsequently contributed down to the Acquisition Company in the form of unsecured loan funds or equity.

Debt push-down structures are often used to optimize the operating and tax position for leveraged buyouts. The most popular model is to establish a local acquiring company by a non-resident holding company that takes on the debt financing and acquires shares in the target (as depicted in the corporate structure above). Subsequently, the Acquisition Company and the target company are merged.

More elaborate structures exist on larger and more complex deals, particularly if any debt funding involves mezzanine funding sources that may need to be structurally subordinated to the senior financiers but rank ahead of any equity contributed by the private equity fund or funds.

The LLC (*spółka z ograniczoną odpowiedzialnością*) and the joint stock company (*spółka akcyjna*) are the two main corporate forms in Poland. They are based substantially on the German GmbH and AG models, each having legal personality with the economic liability of shareholders limited to the amount of their equity contribution. Shares in these kinds of companies are freely transferable unless their statutory documents provide otherwise.

## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

#### *Private company*

For a buyout negotiated in a private context, the primary legal document that records the transaction is invariably the sale and purchase agreement. There may also be other ancillary transaction documents prepared depending on the nature of the deal. These include:

- (a) a separate transfer deed (if the sale and purchase agreement is a preliminary sale and purchase agreement, i.e., subject to conditions precedent);
- (b) a tax indemnity deed;
- (c) an escrow account agreement; and
- (d) a transition/shared services agreement.

#### *Public company*

For a buyout in a public context a tender offer must be prepared if the thresholds referred to in the answer to question 5 have been exceeded. The tender offer is launched by sending notification of the offer to the KNF, the GPW and the Polish Press Agency. The tender offer document (which is a relatively short document with basic information about the purchaser and the terms of the offer) must be published in a Polish newspaper of national circulation.

The management of the target company must give an opinion on the offer before the subscription period commences. There is also a possibility of appointing an independent expert to issue a fairness opinion; in that case, the opinion must also be published. Typically parties also enter into a sale and purchase agreement that records the terms of the sale and acquisition and the rights and liabilities of the parties.

## Banking

The main banking document is the senior facilities agreement under which the senior debt facilities are documented. The debt is governed by strict terms and conditions that include providing for a future set of first ranking securities in favor of the lender in relation to the target's operating assets and the shares of the target, usually established on completion of the acquisition of the target. The standard types of security are a pledge, registered pledge and mortgage, and these have priority in enforcement proceedings. The facility documentation is usually based on the Loan Market Association (LMA) standard.

If there is subordinated or mezzanine debt, there is typically a separate facility agreement under which that debt is made available and an intercreditor or subordination deed recording the respective rights of the senior and subordinated/mezzanine lenders. In any event, that second-ranked debt is subordinate to the senior debt, secured by the second-ranking securities over the target's assets/shares, or often is unsecured. If it is an unsecured loan it would be subject to a high rate of interest, as the subordinated/mezzanine lenders are encumbered with high risk.

Fees are usually recorded in a separate letter rather than in the main facilities agreement.

### 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

In a private context, buyer protections usually take the form of negotiated warranty and indemnity coverage from the seller (being either the shareholder(s) in a share sale, or the company from which the business and assets are being acquired). The terms of that coverage vary from transaction to transaction. However it is quite normal to expect that limits be placed in relation to that coverage, including claim thresholds and caps, time limits and adjustments for items otherwise disclosed or accounted for. In some cases, buyers also place a portion of the sale proceeds in an escrow account for a certain period. Warranty & indemnity insurance products are rarely seen in this market.

In a public context, the level of buyer protection that can be obtained is much lower than in a private context. The primary form of protection usually takes the form of conditions precedent to the acquisition (that either need to be satisfied or not be triggered). The scope of protection under warranties and representations made by target shareholders is very limited and generally only extends to confirmation regarding unencumbered title and due authority to sell.

### 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

There is no formal regulation in relation to how conflicts are managed in a management buyout. However, the Polish Commercial Companies Code (CCC) does impose certain general statutory obligations on directors and officers of a corporation not to misuse their positions or improperly use information of the corporation for, their own advantage.

General fiduciary obligations also dictate that directors and officers must not place themselves in a position of conflict.

Additional restrictions are provided for public companies by which persons discharging managerial responsibilities within a listed company (such as members of management and the supervisory board,



proxies, or senior officers) may not engage in transactions in the target company's shares (or other securities connected with those shares) during a 'closed period'. Generally this means the period:

- (a) until sensitive information is publicly disclosed;
- (b) in the case of an annual report, two months prior to publication of the report;
- (c) in the case of a semi-annual report, one month prior to publication of the report; and
- (d) in the case of quarterly reports, two weeks prior to publication of that report.

## 10. How are the equity arrangements typically regulated in a buyout?

The equity arrangements in a typical buyout are regulated primarily by a shareholders agreement. The relevant company's articles of association may also include specific share rights or personal rights of the shareholders giving special additional profits.

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

Generally, under Polish law there is flexibility regarding the types of equity security that can be issued and the level of rights tailoring that can occur. It is common to see different classes of shares issued to management and the private equity fund in a buyout.

There are rules under Polish law regarding sources of funding that can be used to redeem shares. Additionally, for a joint stock company there are rules that impose limitations in relation to votes (maximum two votes per share) and dividend preferences (maximum additional 50% of dividend) for stocks.

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

### Limited liability company

A limited liability company is managed by a management board consisting of one or more members appointed by the shareholders (unless the articles of association provide otherwise). The management board must be composed of one or more members. Certain strategic decisions, in particular those relating to approval of annual reports, distribution of profits, claims for the reparation of damages, etc., are made at the shareholders' meeting.

As a rule, it is not necessary for a limited liability company to have a supervisory body in addition to the management board. Indeed, often limited liability companies with only one shareholder do not have a supervisory body, but the articles of association may provide for a supervisory board or audit commission, or both. In those cases, the articles may also prohibit individual supervision by shareholders.

However, in companies that have a share capital in excess of PLN 500,000 and where the number of shareholders exceeds 25, the appointment of a supervisory board or an audit commission is mandatory. The supervisory board consists of at least three members and is obliged to exercise supervision of the company's activities at all times. Its competencies include examination of financial statements, reports and motions of the management board regarding the distribution of profits or how to account for losses.

### Joint stock company

The joint stock company is the corporate form usually used for large undertakings that require substantial capital. The minimum share capital is PLN 100,000. Shares in a joint stock company are

freely transferable unless the company's statutory documents, such as the articles of association or statutes, provide otherwise. The statutes of a joint stock company may provide for two categories of shares:

- (a) bearer shares (the transfer of which may not be restricted); and registered shares (where transfer may be restricted).
- (b) The management board comprised of one or more members represents the joint stock company. The board members are usually appointed by the supervisory board.

A joint stock company must also have a supervisory board consisting of at least three members (or at least five members in the case of publicly listed companies), who are appointed by the general meeting. The company's articles of association/statutes, however, may provide for other methods of appointment. The supervisory board is required to exercise constant supervision over the company's activities in all areas of its business, and its duties include, in particular, examination of the financial statements and review of the management board reports and motions regarding the distribution of profits and accounting for losses, as well as the submission of annual written statements reporting its findings to the general meeting of shareholders. The supervisory board is competent to suspend all or individual members of the management board for 'important reasons' and to temporarily substitute one of its own members to perform the functions of a suspended, dismissed or otherwise unavailable management board member.

Each director has one vote but in the case of a tied vote, the president of the management board may have the casting vote. The articles of association may also grant the president certain powers in relation to the management of the activities of the management board.

Generally, issues regarding the board composition, differences in voting rights and the removal of directors are all governed in the company's articles of association and the relevant shareholders agreement. It is common for private equity funds to have specific appointment and removal rights in respect of a certain number of directors in relation to their portfolio companies.

### **13. What measures are commonly used to give a private equity fund some level of control over key operating and financial decisions made by a portfolio company?**

Control over key operating and financial decisions made by a portfolio company is generally obtained via a shareholders agreement and is common. It is achieved by the private equity fund having under the shareholders agreement:

- (a) the right to appoint one or more directors to the board of the portfolio company;
- (b) the right to appoint a majority of the members of the supervisory board (the body entitled to exercise constant supervision over the company's activities in all areas of its business as described above in question 12);
- (c) certain rights to receive information in relation to finances and activities on a regular basis; and
- (d) specific consent or veto rights over particular decisions of the LLC portfolio company, including decisions that relate to operational or financial matters. (Note that this is not possible in a joint stock company.)



## 14. What employment terms are generally imposed on management in a buyout?

It is common for senior members of a management team in a buyout to enter into an executive services agreement. Generally speaking agreements of this kind do not provide for any fixed employment period, but contain provisions dealing with the period of notice that must be applied before the employment terminates. This period is a matter of negotiation and commonly varies depending on the seniority of the relevant manager.

It is also common for remuneration under these agreements to include a fixed component and a bonus related to performance.

Equity incentives offered to management are almost invariably covered in a shareholders agreement rather than an executive services agreement.

Moreover, it is common in Poland for the key members of the management team to work under management contracts, which are not treated by the law as employment contracts and that allow the regulation of mutual rights and obligations without restrictions imposed by employment law.

## 15. What equity incentives can be offered to management and how are they typically structured?

There is a great deal of flexibility in relation to incentives offered to management. These incentives generally take the form of ordinary equity or options over ordinary equity.

Management may be offered a 'ratchet' on their equity that gives them a greater overall return if the investment for the private equity fund outperforms certain base return thresholds (usually measured by reference to the fund's internal rate of return on the investment or an absolute money multiple). Ratchets are typically set out in stock options and will generally only crystallize once the fund has achieved a full exit of its investment.

In certain cases, management equity plans are adopted to regulate the way in which management equity is issued (which can include earning or vesting of the equity over a period subject to achievement of agreed financial hurdles) and can be reacquired by the portfolio company if a manager ceases to be employed for any reason. Good leaver and bad leaver provisions are very common (either in the shareholders agreement or the relevant incentive plan terms) and will effectively give the portfolio company (or its other shareholders) the right to acquire the equity at a pre-determined price in a leaver situation.

## 16. How are buyouts typically debt financed and secured?

While this varies from transaction to transaction, typically 60-80% of the cost of an acquisition is provided from debt provided by banks and financial institutions. The amount of debt that can be raised is typically calculated as a multiple of EBITA.

As leveraged buyouts are becoming more popular in Poland, banks in Poland expect or should be provided with the following information:

- (a) the precise value of the required assets;
- (b) the structure of the transaction;
- (c) the 'debt capacity' of the target;
- (d) the amount of its own capital/equity the investor is prepared to invest in the project;
- (e) the proposed security structure;

- (f) precise details about the sources of repayment; and
- (g) confirmation that the value of a target will grow as a result of operating activities over the financing period.

Polish banks are more willing to finance a buyout of a company if its main assets are tangible.

Lenders usually expect the equity to be structurally subordinated to the debt finance with the debt being lent to a special purpose finance company that is a wholly-owned subsidiary of the holding company.

Security is typically established over all of the assets of the special purpose vehicles and (subject to compliance with the financial assistance regulations) the target companies. These companies also cross-guarantee their obligations to the bank lenders.

## 17. Are there financial assistance issues to consider when undertaking a buyout?

The term ‘financial assistance’ under the CCC refers to all forms of financial support granted by a company to a third party to allow that third party to acquire shares in that company or the shares of its holding companies.

Financial assistance provided by a company may therefore include granting loans, issuing promissory notes, making advance payments and granting the relevant security (e.g., guarantees, pledges or mortgages) in favor of an entity acquiring underlying shares. However, the notion of financial assistance does not encompass payments that, by virtue of a corporate relationship, are made to shareholders. Therefore, payment of dividends or payment for redeemed shares is not considered to be financial assistance.

Under Polish law, financial assistance prohibitions only apply in relation to a joint stock company (there are no equivalent regulations in relation to an LLC). Provisions introducing certain rigorous conditions (as described below) to be met in order to validly grant financial assistance, apply only in relation to joint stock companies.

### Whitewash

Under Article 345 of the CCC, there is a general rule that financial assistance is allowed in relation to a joint stock company, if certain conditions outlined in Article 345 §2-5 of the CCC are met.

Under Article 345 §1 of the CCC, a joint stock company is authorized to finance, directly or indirectly, the acquisition or/and subscription of its shares, in particular by granting loans, making advance payments or providing security provided that the acquisition or subscription is made:

- (a) on market terms, in particular with regard to the interest received by the company or security created for the benefit of the company on account of the loans made or advances paid, as well as after the solvency of the debtor has been checked;
- (b) at a fair price;
- (c) further to an earlier creation of a reserve capital for that purpose, from the amount which may be allocated for division using the company’s distributable reserves;
- (d) after a resolution of the shareholders’ general meeting based on the written report issued by the management board setting out:
  - (i) the reasons for the financing;
  - (ii) the advantages the company will enjoy as a result of the financing;



- (iii) the influence the financing may have on the financial condition of the company issuing the shares;
- (iv) detailed financing conditions;
- (v) the security to be established; and
- (vi) the fair price.

In relation to financial assistance by companies that are not joint stock companies), the above requirements of the CCC do not apply. Those companies therefore may grant financial assistance generally without direct legal restrictions except in relation to corporate benefit, which is discussed below in question 18.

## 18. What are the implications under the corporate benefit laws of Poland for a company providing financial assistance?

### Corporate benefit

As a matter of principle, a company established under Polish law must carry out its business for its own benefit and the actions it performs must be reasonably justifiable. A company is not required, however, to always receive consideration on market terms in relation to the arrangements that it enters into. Nevertheless, it must be possible for the company to show, at least in the long term, that it has received a benefit in relation to the acts it carries out.

### Granting security

If a Polish company grants security in relation to a facility agreement it is advisable for it also to be a debtor/obligor under the facility agreement and the beneficiary of the financing made available under the facility agreement. This would create a legitimate reason for the Polish company to grant the security interest. Otherwise it is possible that the granting of the security by a Polish company may be deemed (by the company itself or its shareholders) to be detrimental to the company.

If a security granted by a Polish company is deemed (in a court proceeding) to be detrimental to the company, it could result in personal liability of the management board of the company for the damage caused in connection with the granting of the security interest.

### Creditors

It is also important to note that the lack of corporate benefit may affect a company's external relationships. Acts of the company with no, or hardly any, benefit to the company may be criticized by the company's existing creditors for being carried out to the detriment of those creditors and therefore may be held to be ineffective in relation to those creditors. In those circumstances each creditor may demand that the court declares the relevant act to be ineffective in relation to them. It is, however, usually relatively difficult for the creditors to have this demand satisfied before the court due to evidentiary hurdles. If the relevant act of the company was carried out with no consideration, it would be easier for the creditors to prove that the act was performed to their detriment.

### Disposal of assets on bankruptcy

Moreover, acts carried out by the company, which bring no, or hardly any, benefit to the company may be held to be ineffective against the bankruptcy estate if the company is declared bankrupt.

Therefore, any act by which the bankrupt company disposed of its assets (e.g., by encumbering them), carried out by the bankrupt within:

- (a) two months before the filing of the bankruptcy application will have no effect on the bankrupt estate if that act was performed in relation to the repayment or securing of a debt not actually due;
- (b) six months before the filing of the bankruptcy application will have no effect on the bankrupt estate if the act was carried out (even for consideration) by the bankrupt with a shareholder, dominant company or affiliated company, dominant company's or affiliated company's shareholders as well as their proxies;
- (c) one year before the filing of the bankruptcy application will have no effect on the bankrupt estate if that act was performed with no consideration, or if for consideration, where the value of the bargain the bankrupt is obliged to perform is drastically in excess of the bargain received by the bankrupt company.

If the acts of a Polish company can be shown to be reasonably justifiable and there is a legitimate benefit to the company in relation to those acts, the company's risk of court actions by creditors and transactions being set aside if it becomes bankrupt are minimized.

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

Generally, under Polish insolvency laws secured creditors have higher priority than unsecured creditors. Creditors holding security interests such as mortgages, registered pledges and civil law pledges enjoy priority in relation to satisfaction of claims from the amounts obtained from the liquidation of those assets irrespective of the plan of distribution of the funds of the bankrupt estate.

According to the Polish Bankruptcy and Reorganization Law, the sums recovered from the sale of assets and rights encumbered by a mortgage, pledge, registered pledge, treasury pledge or maritime mortgage are used in the first instance to satisfy those creditors whose receivables were secured by assets and rights that have been sold. These rules, relating to the satisfaction of creditors from the bankrupt estate, are subject to certain limitations such as the obligation to satisfy as a priority the obligation to pay out remuneration for work performed by the employees of the bankrupt entity for the period of three months directly prior to the relevant insolvency date.

There are no special provisions regarding shareholders, however, during the insolvency procedure the shareholders rank behind secured and unsecured creditors. Moreover, a shareholder's claim under a loan extended by a shareholder will be deemed to be a contribution of that shareholder to the company if it is declared bankrupt within two years of the date of the loan agreement.

Additionally, certain unsecured creditors (e.g., employees, the State Treasury in relation to taxes, the social security office) may have priority over other unsecured creditors because the Bankruptcy and Reorganization Law provides for a fixed organized list of categories detailing the order/priority in which the claims will be satisfied.

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

A number of Polish tax issues are relevant. Key issues commonly are set out below.

### Overall tax treatment of the structure

The form and jurisdiction in which the entity investing in the Polish assets is located is crucial for the tax effectiveness of the structures. A key issue for dominant non-resident investors is whether the relevant entity may benefit from participation exemption on exit, and from treaty protection or protection under the EU tax directives implemented into Polish tax law.



## Deductibility of investment costs

Interest on funding used to finance the acquisitions of shares may potentially be deductible for Polish tax purposes. As set out in question 6, debt push-down structures are often used to optimize the operating and tax position for leveraged buyouts. The most popular model is to establish a local acquisition company by a non-resident holding company that takes the debt financing and acquires shares in the target. Subsequently, the local acquisition company and the target company are merged. To be implemented safely these structures require advance clearance from the tax authorities in the form of a binding tax ruling.

## Transfer taxes/stamp duty

The tax on civil law transactions (**TCLT**) may be an important consideration when structuring private equity deals. TCLT is imposed on the sale of shares and other property rights (i.e., securities, receivables) at the rate of 1% of the fair market value of those instruments and it is payable by the purchaser.

Further:

- (a) a 2% TCLT generally applies to loans (a full exemption applies for a shareholder loan to a company, and a 0.5% TCLT applies to loans to partnerships by partners);
- (b) a 0.5% TCLT applies to an increase in share capital; and
- (c) a 1% or 2% TCLT generally applies to the transfer of assets under sale/exchange agreements. The 2% rate is applicable to the transfer of tangible assets (such as real estate, movable assets), while 1% is applicable to the transfer of intangible assets (e.g., trademarks, goodwill).

There are, however, numerous strategies used to minimize the TCLT burden. In particular, transactions that are subject to VAT (or those which would be subject to VAT but for an exemption) are not, as a rule, subject to TCLT (with certain exceptions regarding e.g., real estate). Also, some transfers of assets which are not executed under the sale/exchange agreement are out of the scope of TCLT.

## Withholding taxes

For non-resident investors withholding tax is an important issue to the extent returns will be repatriated by way of dividends, interest or royalties. Generally, dividends are subject to a 19% withholding tax. Interest and royalties are subject to a 20% withholding tax.

### *Exemptions for dividends*

For dividends, there is an exemption under regulations implementing the EU Parent-Subsidiary Directive. The exemption is available in Poland for dividends (and other dividend-type income) paid to EU/EEA/Swiss shareholders holding at least 10% (the threshold is 25% for Swiss shareholders) for an uninterrupted period of two years. For interest and royalties, the exemption may be claimed under regulations implementing the EU Interest-Royalties Directive. The exemption is available in Poland for interest and royalties paid to a company:

- (a) being a tax-resident in a EU/EEA member country or in Switzerland;
- (b) that holds at least 25% of shares in the capital of the Polish subsidiary making the payment;
- (c) in which the Polish entity making the payment holds at least 25% of shares in the capital; or
- (d) in which at least 25% of shares in the capital are held by another company being a tax-resident in a EU/EEA member country which also holds at least 25% of shares in the capital of the Polish company making the payment.

In order to apply the exemption the above shareholding must be held for an uninterrupted period of two years.

## Income tax

### *General*

The exit from a particular investment can be structured in a tax effective manner.

From the perspective of the Polish corporate or individual seller, the capital gains on the sale of the shares will be subject to 19% corporate income tax (**CIT**) or personal income tax (**PIT**). There is no universal scheme under which such capital gains could be exempt from taxation, so share deals are most attractive tax-wise if the seller is a Polish non-resident entity protected from Polish taxation under the relevant tax treaty.

In particular, if the shares in a portfolio company are held by non-residents, the capital gain may often be exempt on the basis of a tax treaty between Poland and the country of the investor. The exemption under the tax treaties is often restricted in relation to real estate rich companies (although full exemption is possible for investors investing in real estate companies via e.g., the Netherlands or Cyprus holding companies).

Further, investment funds that are fully exempt from Polish CIT can sell their portfolio companies without a capital tax burden on exit.

### *Individual investors*

Individuals having their tax residence in Poland are subject to PIT on their worldwide profits, irrespective of the location of the source of income. Individuals who are non-residents in Poland are subject to PIT only in relation to the profits that they derive within Poland.

Income from dividends and other dividend type income (e.g., redemption of shares, the liquidation of a company), interest and investments in investment funds are subject to PIT at the flat rate of 19%. This relates to both income earned in Poland and abroad (e.g., from investment in foreign entities). Withholding taxes paid on the income derived from abroad can be deducted from the Polish tax payable although the amount of the deduction cannot exceed the amount of tax calculated in Poland.

Income tax on capital gains earned on the disposal of securities is payable at the rate of 19% of income earned. Income earned on the disposal of shares is the difference, in a given calendar year, between revenue earned on the disposal of shares (i.e., value of the shares understood as a price specified in a sale agreement, and costs incurred on an acquisition and a disposal of shares). If a price differs significantly from the market value of shares without a justified reason, the tax authorities can adjust the income to a market level. After the end of a given calendar year, taxpayers who earned income on the disposal of shares are required to declare that income in an annual tax return, and to calculate the amount of income tax due. These regulations do not apply if a disposal of shares is effected as part of a taxpayer's business activity; then, income is taxed as business income.

The above rules may be modified under the tax treaties with the countries of residency of non-resident investors.

### *Corporate income tax*

Corporate investors that are tax residents in Poland, are subject to Polish CIT on their worldwide income irrespective of the country from which the income is derived. The entities that do not have their registered seat or their management in Poland, are subject to Polish corporate income tax only in relation to the profits that they derive within Poland.

Income earned by Polish legal persons on disposal of shares or on participation in investment funds is subject to corporate income tax in Poland in accordance with the general rules (imposed at the rate of



19%). Income earned on a disposal of shares is the difference between an amount earned through a disposal of shares (i.e., the value of shares understood as the price specified in a sale agreement, and the costs incurred on an acquisition and the disposal of the shares).

Dividends and other similar income from sharing in the profits of Polish/foreign entities are subject to corporate income tax of 19%. Tax paid abroad on that income can be deducted from the Polish tax payable although the amount of foreign tax deducted cannot exceed the Polish tax on this income calculated as a proportion of total tax payable.

An exemption is available in Poland for dividends (and other dividend-type income) received from EEA/Swiss/Polish entities if the Polish investor holds at least 10% (25% for Swiss shares) for an uninterrupted period of two years.

## 21. What forms of exit are available?

If an entity is solvent the most common forms of exit are an IPO or a trade sale (either a sale of shares or a sale of the underlying business). It is fairly common for private equity funds to run a dual track process on any exit, where both forms of exit are prepared for, to test which form of exit offers the best pricing and terms.

It is also not uncommon for private equity funds to achieve a return on their investment during the life of the investment by undertaking a leveraged recapitalization. In that case, the return can take the form of a dividend and/or some other form of capital distribution or buy-back.

## Singapore

### 1. What structures do private equity funds typically use to manage their funds?

The structure commonly used by private equity funds to manage the funds raised from their investor base is the exempt limited partnership that is commonly constituted in the Cayman Islands for tax purposes. In more recent years, Singapore has also emerged as a viable jurisdiction to domicile a limited partnership. The investors hold limited partnership interests in the partnership and there is a general partner who takes day-to-day management control of the partnership and its operations. The fund typically enters into a fund management agreement with a fund management company in Singapore (and other relevant jurisdictions as appropriate) to advise on the fund management activities of the fund in the region.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in Singapore?

A private equity fund does not need to be licensed in Singapore. However, the offering of units in a fund is a form of securities offering in Singapore that is regulated by the Securities and Futures Act.

The only regulatory oversight in the fundraising process in Singapore is the licensing of any person who carries out a fund management business in Singapore. A fund management company needs to obtain a capital markets services license from the Monetary Authority of Singapore (**MAS**) to carry out fund management activities in Singapore unless it qualifies for one of the various exemptions from requirements to hold a license as set out under Schedule 2 to the Securities and Futures (Licensing and Conduct of Business) Regulations (**SFR**). The exemptions include:

- (a) the ‘Related Corporation Exemption’ (paragraph 5(1)(b) of Schedule 2 to the SFR) – a corporation which carries on business in fund management for or on behalf of any of its related corporations, so long as in carrying on such business, none of the securities, positions in futures contracts, or foreign exchange arising from foreign exchange trading or leveraged foreign exchange trading being managed, are:
  - (i) held on trust for another person by the second-mentioned corporation;
  - (ii) the result of any investment contract entered into by the second-mentioned corporation; or
  - (iii) beneficially owned by any person, other than the first-mentioned or second-mentioned corporation; and
- (b) the ‘Qualified Investor Exemption’ (paragraph 5(1)(i) of Schedule 2 to the SFR) – a Singapore company undertakes fund management activity in Singapore on behalf of not more than 30 qualified investors (subject to certain other conditions).

Persons who carry out the fund management activities for the fund are also required to be registered with the MAS as representatives of the fund management company unless it is exempted from being so registered by the Securities and Futures Act.

### 3. Are there any approvals required for investments by foreigners in Singapore and, if so, what is the process?

Generally, investments made by foreigners (e.g., foreign government, non-Singaporean citizens, foreign incorporated companies, etc.) in Singapore are not subject to the approval of any governmental or regulatory agency in Singapore except for companies in certain regulated industries such as banking, insurance, securities and telecommunication. If the investments relate to companies



in these regulated industries, there are also statutory provisions restricting the transfer of shares and/or share capital requirements that must be met.

For example, a broadcasting company will not be granted the relevant licenses (subject to the approval of the Info-communications Development Authority of Singapore), if a foreign source holds 49% or more of the shares of that company (or its holding company).

Further, any acquisition causing the acquirer to own 5% or more of shares or voting power of a local finance company or a local insurance company (and any additional acquisitions exceeding the 12 % or 20 % thresholds) require approval from the Minister of Finance of Singapore. This is regardless of whether the acquisition is by a foreigner or a non-foreigner.

#### 4. Who are the relevant regulators in Singapore and how much interaction would one generally expect when undertaking a buyout?

The primary regulatory authorities in Singapore in a corporate context are:

- (a) Monetary Authority of Singapore (**MAS**) – administers the statutory laws regulating capital markets and maintains oversight of Singapore Exchange Limited’s regulatory responsibilities;
- (b) Singapore Exchange Limited (**SGX**) – has frontline regulatory responsibilities over the securities and futures markets and the broker-dealers who trade on the exchange;
- (c) Securities Industry Council (**SIC**) – non-statutory body which administers the Singapore Code on Take-overs and Mergers (**Takeover Code**);
- (d) Competition Commission of Singapore – for competition issues arising from acquisitions;
- (e) Accounting & Corporate Regulatory Authority – monitors corporate compliance with disclosure requirements imposed on companies and businesses, and regulates public accountants performing statutory audits; and
- (f) Inland Revenue Authority of Singapore – the taxation authority.

The level of expected involvement with the MAS, SGX and the SIC in a buyout situation depends to a large extent on whether the transaction involves a public company or a private company, the nature of the transaction and the parties concerned. Transactions involving public companies such as a public takeover generally result in greater interaction with the stated authorities than a transaction involving a private acquisition.

In a public company takeover, investors would typically need to consult with the SIC in relation to whether the takeover is compliant with the Takeover Code, and to respond to any queries that the SIC may have regarding the takeover. The takeover process must also comply with the SGX Listing Manual, and therefore appropriate clearance or approval from the SGX would have to be sought. For example, a trading halt will have to be requested, and disclosures will have to be made through announcements via the SGX.

#### 5. How are buyouts typically undertaken in the private and the public markets?

##### Private companies

In relation to private companies, a buyout is generally undertaken by way of a private acquisition that is concluded after negotiations between the parties. The parties negotiate and execute a sale and purchase agreement that records the terms and conditions of the acquisition as well as the rights and liabilities of the parties involved.

## Public listed companies

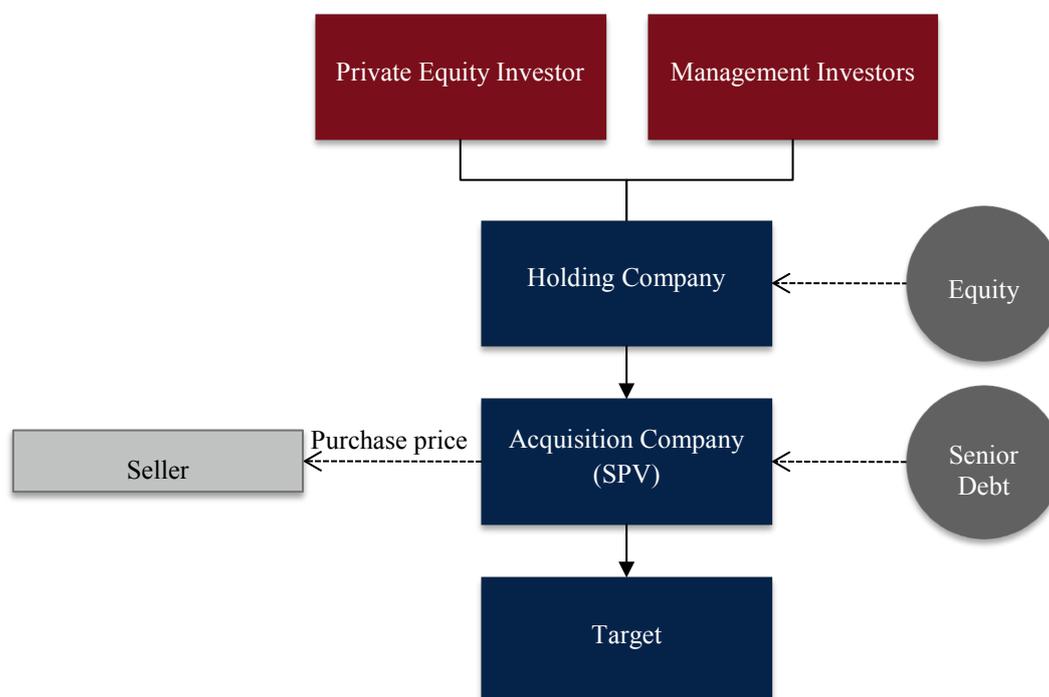
In relation to public listed companies, a buyout is typically undertaken by way of a takeover bid or by way of a scheme of arrangement, both of which must comply with applicable statutory provisions that govern the process of the takeover or scheme of arrangement.

A takeover bid is governed by the Takeover Code and the SGX Listing Manual which are administered by the SIC and SGX respectively. The takeover bid may be by way of a mandatory offer or voluntary offer. A mandatory offer involves the investor acquiring shares in the target company via share purchase agreements, followed by the making of a mandatory general offer for the remaining shares in the target company not already owned or agreed to be acquired by the investor. A voluntary offer involves the investor making a voluntary general offer to purchase all the shares in the target company, with the offer being subject to an acceptance level condition.

The statutory provisions relating to a scheme of arrangement are in Section 210 of the Companies Act. For a scheme of arrangement to be implemented, the scheme must be approved by the shareholders affected by the scheme in a shareholders' meeting, and by the Singapore courts. As a scheme of arrangement qualifies as an offer under the Takeover Code, an exemption from compliance with the requirements of the Takeover Code must also be sought from the SIC.

## 6. What is the typical corporate structure used when doing a buyout?

The choice of corporate structure used when undertaking a buyout is typically tax driven. One buyout structure that is commonly seen is a two-level holding company structure as follows:



This type of structure allows for the senior debt financing to be provided to the special purpose vehicle incorporated as the acquiring company (Acquisition Company SPV), and the holding company subscribes for shares in the Acquisition Company (thereby injecting capital into the Acquisition Company). More elaborate structures are used on larger and more complex deals.



## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

#### *Private companies*

Typically, before negotiations begin for a buyout (in relation to both private and public companies), the investor and the target company sign a confidentiality agreement.

Negotiations usually begin with the circulation of a term sheet or memorandum of understanding that is a summary of points agreed, or to be agreed.

After due diligence in relation to the target company is completed, the share purchase agreement, subscription agreement or investment agreement are executed by the relevant parties. Typically, a shareholders agreement is also entered into by the investor, target company and existing shareholders of the target company if the company is not wholly acquired. A shareholders agreement may also be entered into between the target company and the multiple new investors wholly acquiring the target company, or if a holding company is to be incorporated, between investors and the holding company to govern the operation of the holding company.

#### *Public listed companies*

For a buyout of a public company via a takeover bid, an offer document must be issued by the investor to the shareholders of the target company. The offer document sets out the details, and terms and conditions of the offer to the target company's shareholders. The target company's board must subsequently advise its shareholders about its views in relation to the offer, typically through an offer circular.

If the buyout is via a scheme of arrangement, a merger agreement/implementation agreement is used to set out the terms of the scheme (including conditions precedent, pre-completion undertakings from the target company, warranties from the target company itself, or from substantial shareholders of the target company). Typically, irrevocable undertakings with major shareholders to vote in favor of the scheme are sought. Other documents prepared include a scheme circular, and miscellaneous court documents for the approval of the scheme.

#### *Other documents*

Other corporate documents that may be prepared when undertaking a buyout in Singapore include employment agreements between key employees and the target company, employee share option plans (for those employees who are not taking a direct equity participation in the holding company), management or service agreements and a registration rights agreement if a future listing on a U.S. investment exchange is viewed as a likely route for an eventual exit.

### Banking

The main banking document is the facilities agreement under which the terms of the loan made to the company are documented. In addition, if the transaction is secured, separate security documents are executed to provide the lender with security for the obligation to repay the loan. The nature of the security depends on the circumstances and can include fixed and floating charges, share charges and other forms.

If there are different debt providers, their relative positions depend on subordination and other contractual arrangements negotiated between the parties. Where there are different types of debt finance, subordination is typically implemented through an intercreditor agreement. One common arrangement in Singapore is structural subordination, where a senior creditor lends to a company

(usually one of the operating subsidiaries in which assets are held) that is lower in the group structure than the company to which the junior creditor lends.

## 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

A private equity fund usually seeks a full range of warranties and indemnities from the seller and management as a form of buyer protection when undertaking a buyout (though for a buyout of a public listed company, the range of warranties and indemnities agreed on may be narrower).

Part of the purchase consideration may be withheld or placed in escrow for a fixed period to meet any warranty or indemnity claim. Warranty & indemnity insurance is also a commonly used tool to manage risk for the buyer. It is also common for a private equity fund to set conditions precedent for the acquisition which need to be fulfilled (or not triggered, as the case may be) by completion.

## 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

There are no specific laws regulating how conflicts of interest must be managed in a typical management buyout.

### Conflicts of interest

Management may be in a position of conflict due to the contractual obligations it owes to the target company under any service agreement. Service agreements would typically include obligations such as confidentiality obligations, non-compete obligations or the duty of a manager to devote full time and attention to the discharge of his or her duties. To the extent that a manager may need to disclose information in relation to the company to his or her advisers or financiers, this disclosure would breach any confidentiality obligations. A manager would invariably be distracted from performing his or her everyday managerial duties while the buyout is being negotiated, and would therefore not be able to devote full time and attention to the target company. Lastly, a manager may be in breach of non-compete undertakings that may exist in his or her employment contract by mounting a management buyout bid.

If a manager is also a director of the target company, the Companies Act imposes general statutory obligations on directors to act honestly and use reasonable diligence in the discharge of their duties at all times. Further, directors may not engage in any improper use of any information acquired by way of their position in the company to gain an advantage for themselves or any other person or cause a detriment to the company.

Directors also owe fiduciary duties to act in good faith and in the best interests of the company and not to put themselves in a position of conflict.

### Public listed companies

For public listed companies, the SGX Listing Manual, which sets out requirements which apply to issuers of securities, provides that an issuer of securities must make an immediate announcement of any interested person transaction (equal to or above the value of SGD 100,000) which is of a value equal to or more than 3% of the group's latest audited net tangible assets. If the figure is 5% or more, the issuer must obtain shareholder approval. An interested person transaction is defined as a transaction between an entity at risk (the issuer) and an interested person (director, chief executive officer, controlling shareholder of the issuer).



## 10. How are the equity arrangements typically regulated in a buyout?

The equity arrangements in a buyout are typically regulated by a shareholders agreement entered into by the existing shareholders of the target company and the new investors. If the buyout structure is such that a holding company/Acquisition Company is incorporated to acquire and hold the target company, the equity arrangements are regulated by a shareholders agreement entered into by the new shareholders and the holding company. Further, the memorandum and articles of association of the target company, or the holding company (if the structure is such that a holding company is incorporated) is often amended to include the specific share rights that attach to the relevant classes of security to be issued in relation to the buyout.

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different shareholders?

Generally, Singapore law does not impose any restrictions on the classes of equity security that can be granted, or the level of rights tailoring that can occur between different stakeholders in a buyout. Shares having any type of rights may be created as designated among the shareholders of the company. Typically, the classes of equity security include ordinary shares, preference shares or convertible debt instruments with the latter two favored by private equity investors.

The Companies Act provides for certain rules in relation to the redemption of redeemable preference shares. These include a prohibition on the redemption of shares out of the capital of the company unless all the directors have made a solvency statement in relation to the redemption, and the company lodging a copy of the solvency statement with the Registrar of Companies. The company has a further obligation to notify the Registrar within 14 days on the redemption of any redeemable preference shares and specifying the shares redeemed.

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

Typically, the shareholders agreement sets out the relationships, rights and obligations between the investor, the target company and the existing shareholders of the target company. Depending on the buyout structure, the shareholders agreement may be in relation to the target company (if the buyout is via direct investment) or the Holdco/Topco (if the buyout is via an investment holding company). The shareholders agreement and the articles of association of the target company or the holding company/Acquisition Company (as the case may be) typically govern matters concerning board constituency, differential director voting rights and the removal of directors.

There is no provision in the Companies Act that prescribes the manner in which directors are to be appointed. There are certain exceptions however in relation to specific groups of people, for example, an undischarged bankrupt being disallowed from holding directorships. The appointment and removal of directors is usually dealt with in the company's articles of association.

## 13. What measures are commonly used to give a fund some level of control over key operating and financial decisions made by a portfolio company?

The fund usually has representation on the board of a portfolio company if it wishes to have a direct say in the management and direction of the portfolio company. Representation on the board may also include a presence on the audit and compensation committees. A shareholders agreement or the memorandum and articles of association of a company can entrench the fund's right to appoint a majority of members to the board for private limited companies. It may also be possible for the fund to appoint directors at the target company level (or holding company/Acquisition Company level as

the case may be) only, and reserve (but not exercise) the right to have representation on the boards of the portfolio companies.

The fund may create particular corporate governance and approval authority workflows to impose restrictions on the management in relation to undertaking any fundamental matters (such as a major acquisition or disposal) or large projects without board approval. The fund may also create information requirements so that the target company would have to report to the fund about certain matters or decisions.

The banking documents would also contain negative covenants and information requirements.

#### **14. What employment terms are generally imposed on management in a buyout?**

A fund would typically want to offer incentives to key employees to maximize the value of the business, but at the same time, would wish to protect the business if a key employee departs or underperforms.

The terms of employment are set out in an employment contract or service agreement which includes key employment terms such as non-compete clauses, confidentiality clauses and provisions for 'garden leave' to mitigate risks when key employees resign. Incentive plans tied to company performance may also be introduced to ensure the long-term retention of the management. Incentive plans may include share incentive plans under which employees are granted shares in the holding company. The rights and obligations attached to these shares would be set out in the shareholders agreement in relation to the holding company between the fund and the management or, if appropriate, in the relevant company's articles of association.

#### **15. What equity incentives can be offered to management and how are they typically structured?**

Generally, incentive plans for management are structured on a long-term basis. However, short-term incentives based on annual results are not uncommon.

##### **Stock options/equity**

If the fund decides to take the company public, stock options (with or without lock-ups) are a typical incentivization used in Singapore. In a management buyout, equity may be offered to management in the target company or in the holding company to provide an incentive to management.

##### **Ratchet mechanism**

One common incentive method employed to ensure that the management team is committed to the business of the company is the ratchet mechanism. Such a mechanism enables the relevant percentage of equity held by management and the fund in the target company (or in the holding company or Acquisition Company) to alter according to management's performance. It provides management with an incentive to retain, or increase the amount of, their equity in the company in proportion to how well it performs. The most frequently used ratchet mechanisms include the redemption of the fund investor's shares (where the fund takes a part of its equity in the form of redeemable shares) and variation of rights attached to shares (where the articles of association of the company may be drafted to provide for automatic variation of the rights attached to the fund investor's or management's shares on achievement of performance targets). It should be noted that the type of ratchet mechanism adopted is typically tax-driven.



## Good leaver/bad leaver provisions

Another incentive which may be used in a management buyout is to include good leaver/bad leaver provisions in the shareholders agreement and/or articles of association of the target company or the holding company. These provisions regulate what happens to the management team member's shares if he or she leaves employment. Typically, the investor requires good leavers (who are usually defined as those who leave as a result of death, normal retirement, ill health, permanent disability or dismissal without cause) to sell all of their shares back to the holding company at market value, while bad leavers (i.e., any other leavers) must sell all of their shares at the lower of cost and market value.

## 16. How are buyouts typically debt financed and secured?

The debt finance typically comprises:

- (a) senior debt (from banks, pension and insurance funds and hedge funds); and
- (b) junior debt (which may consist of mezzanine debt, high yield debt and/or PIK debt).

Senior debt is the principal source of debt in buyouts and ranks in priority to junior debt and other subordinated debt. Components of senior debt include term loans and revolving credit facilities. Mezzanine debt ranks behind senior debt but ahead of equity capital. It is usually injected by the fund providing the equity, the vendor (if it wishes to maintain a minority interest) or a senior debt provider (in addition to the senior debt).

Security is likely to be required by both the senior lenders and the junior lenders over all (or substantially all) of the assets of the Acquisition Company and the target group. Security is typically obtained through the usual mortgages and charges (fixed and floating) over the acquired assets, or the shares acquired, subject to compliance with the financial assistance provisions of the Companies Act. Usually, the relative priority of security depends on the contractual arrangements negotiated between the parties.

## 17. Are there financial assistance issues to consider when undertaking a buyout?

### Prohibition

Section 76(1) of the Companies Act prohibits a company from giving any financial assistance for the purpose of, or in connection with, the acquisition by any person of shares in that company or shares in the holding company of that company (**Unlawful Financial Assistance**). Section 76(1)(a) states:

‘Except as otherwise expressly provided by this Act, a company shall not, whether directly or indirectly, give any financial assistance for the purpose of, or in connection with:

- (a) the acquisition by any person, whether before or at the same time as the giving of the financial assistance, of:
  - (i) shares or units of shares in the company; or
  - (ii) shares or units of shares in a holding company of the company; or
- (b) the proposed acquisition by any person of:
  - (i) shares or units of shares in the company; or
  - (ii) shares or units of shares in a holding company of the company.’

The giving of Unlawful Financial Assistance includes (but is not limited to) financial assistance by means of the making of a loan, the giving of a guarantee, the provision of security, the release of an obligation or the release of a debt.

Section 76(3) goes on to provide that a company shall be taken to have given financial assistance for the purpose of an acquisition or proposed acquisition referred to in Section 76(1)(a) (referred to as the 'relevant purpose') if:

- (a) the company gave the financial assistance for purposes that included the relevant purpose; and
- (b) the relevant purpose was a substantial purpose of the giving of the financial assistance.

The Singapore courts will examine the relevant arrangements to determine if there is any Unlawful Financial Assistance or if the relevant arrangements are camouflaging any unlawful financial assistance. One of the key questions the courts may ask is whether the parties would have entered into the acquisition of the shares but for the arrangement in question.

### Whitewash procedures

Sections 76(9A), 76(9B) and 76(10) set out the different whitewash procedures that may be followed to enable a company to provide financial assistance for the acquisition of its shares or shares in its holding company, assuming that there are no other relevant exemptions. The different whitewash procedures can briefly be described as follows:

- (a) director-approved financial assistance under Section 76(9A);
- (b) shareholder-approved financial assistance under Section 76(9B); and
- (c) court-sanctioned whitewash procedure under Section 76(10).

Sections 76(8) and (9) contain a list of items that are expressly carved out from the financial assistance prohibition.

### When contracts may be void

A contract or transaction made in contravention of Section 76(1)(a) is void if it falls within the type of contract or transaction listed in Section 76A(1). All other contracts or transactions in contravention of Section 76(1)(a) are voidable at the option of the company. A 'related' contract or transaction is also voidable. Section 76A(14) defines what 'related' means in this context. Where a company gives financial assistance, any contract or transaction engaged in as a result of, or by means of, or in relation to, the financial assistance is deemed to be a related transaction. Also, if there is a breach of Section 76(1), each officer of the company in default shall be guilty of an offense and liable on conviction to a fine not exceeding SGD 20,000 and/or to imprisonment for a term not exceeding three years.

Before a company can avoid the relevant contract or transaction, notice in writing must be given to the other parties to the contract or transaction. This notice may be given by the company itself or, if the court so authorizes, by a member of the company, a trustee for the debenture holders, a debenture holder or a director. However, a contract or a transaction is not voidable if it is entered into in reliance on a certificate stating that the requirements of Section 76(9A), 76(9B) or 76(10) (as the case may be) has been complied with. This certificate must have been signed by two directors or a director and a secretary. This does not apply if the person relying on the certificate became aware before the contract was made, or the transaction was engaged in, that the requirements of Section 76(9A), 76(9B) or 76(10) (as the case may be) had not been complied with.

### Changes to the financial assistance regime

There will be changes to the financial assistance regime under the Companies (Amendment) Bill No. 25 of 2014 (**Amendment Act**) which is expected to take effect in 2015. The Amendment Act will



amend Section 76 to limit the financial assistance prohibition so that it will apply only to public companies and their subsidiaries. The prohibition will therefore no longer be applicable to private companies whose holding or ultimate holding company is not a public company and those companies will be able to enter into transactions involving financial assistance without having to undertake the 'whitewash' procedures set out in the Companies Act.

## 18. What are the implications under the corporate benefit laws of Singapore for a company providing financial assistance?

In Singapore, directors of a company must act in the interests of the company. Section 157 of the Companies Act provides that a director shall at all times act honestly and use reasonable diligence in the discharge of the duties of his/her office. The phrase 'act honestly' has been interpreted to mean 'acting bona fide in the interests of the company in the performance of the functions attaching to the office of director.'

Directors in Singapore also owe fiduciary duties to the company, as a matter of common law, to act in the interests of the company.

When considering the provision of financial assistance for the acquisition of the company's shares, directors must continue to act in the interests of the company. It should also be noted that corporate benefit should accrue to the company and not just to another company in the group. What amounts to commercial benefit depends on the facts of each case. This is ultimately a question for the court to decide.

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

Singapore insolvency laws provide for a basic ranking of claims among the debtors of the company.

The general law of property applies in these situations and secured creditors take priority over unsecured creditors. Among secured creditors, a legal charge prevails over an equitable charge (unless the equitable charge was created first and the legal chargee knew of the prior charge).

The Companies Act also provides for a class of preferential creditors, such as employees whose wages or salaries are unpaid, that take priority over unsecured creditors if a company is wound up.

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

### Stamp duty

In an acquisition of shares in a Singapore-incorporated company, the buyer generally pays stamp duty at 0.2% of the purchase price or the market value of the shares (whichever is higher) unless relief for stamp duty is applicable. Where the market value of the shares is not readily available, it is generally taken to be the net asset value of the shares. It is possible to agree to the cost to be borne by either or both of the parties by mutual agreement.

### M&A Scheme

The M&A scheme is a specific tax regime introduced by the Singapore government in 2010 to encourage taxpayers to expand their businesses through M&A transactions. A share acquisition may be more advantageous for an acquirer under the scheme if the transaction is a qualifying acquisition. A qualifying acquisition is one that results in:

- (a) the acquirer owning at least 20% of the target's ordinary shares if it owned less than 20% before the acquisition date, or

- (b) more than 50% of the target's ordinary shares if it owned 50% or less before the acquisition date.

Under the M&A scheme, subject to conditions:

- (a) an acquirer acquiring the ordinary shares of a target under a qualifying acquisition during the period 1 April 2015-31 March 2020 (both dates inclusive) is granted an M&A allowance of 25% of an acquisition value of up to SGD 20 million in the relevant year of assessment over 5 years;
- (b) a 200% allowance is granted on transaction costs (e.g., legal fees, accounting or tax advisor's fees and valuation fees) incurred on qualifying acquisitions completed during the period 1 April 2015-31 March 2020 (both dates inclusive), subject to an expenditure cap of SGD 100,000 per year of assessment, and
- (c) stamp duty relief of up to SGD 40,000 per financial year is granted on an instrument of transfer on a sale of ordinary shares under qualifying acquisitions completed during the period 1 April 2015-31 March 2020 (both dates inclusive).

### Taxation at fund level

The tax structure of a fund depends on which form of entity it chooses to adopt. If the form chosen is a company, the tax rate would currently be 17%, while the tax rate of a partnership would be the personal income tax rates. However, there is no capital gains tax in Singapore.

Singapore has tax treaties with many other countries to avoid double taxation of income earned in one country by a resident of another country. There is also a reduction or exemption of tax on certain types of income as set out in the tax treaties.

Singapore tax law contains some tax concessions targeted at promoting the setting up of funds in Singapore. These include enhancements made to fund management tax incentives schemes announced by the Singapore Government in successive annual budgets.

## 21. What forms of exit are available?

In solvent situations, the common forms of exit are via initial public offerings or trade sales to strategic investors or to another private equity firm.

(In insolvent situations, the company may still be sold to another private equity firm or strategic investor if those parties feel that they can derive better value from the insolvent company. In certain situations, the insolvent company may be placed into voluntary or involuntary liquidation and shareholders are returned any cash that remains after the creditors are paid.)

- (a) trade sale/IPO-obligations (e.g., lock-up);
- (b) call/put options other than under the leaver scheme; and
- (c) anti-dilution protection for the management.



## Spain

### 1. What structures do private equity funds typically use to manage their funds?

The principal structures that may be used for private equity funds in Spain are as follows:

- (a) private equity funds (*fondos de capital riesgo*) (**FCRs**);
- (b) private equity companies (*sociedades de capital riesgo*) (**SCRs**);
- (c) private equity funds that invest in Small and Medium-sized Enterprises (SMEs) (*fondos de capital riesgo PYME*) (**FCRs-PYME**); and
- (d) private equity companies that invest in SMEs (*sociedades de capital riesgo PYME*) (**SCRs-PYME**).

#### FCRs

FCRs do not have legal personality and are managed by a regulated third party that acts as a management company. The minimum assets committed to the relevant fund are EUR 1.65 million. FCRs do not need to be registered with the Commercial Registry.

#### SCRs

SCRs have legal personality. The minimum share capital is EUR 1.2 million (note, however, that the minimum share capital required for private equity companies that invest in SMEs is EUR 900,000), 50% of which must be paid up on the incorporation of the SCR and the remainder of which must be paid up within three years from the date of incorporation.

#### FCRs-PYME/SCRs-PYME

The basic requirements for private equity companies/funds investing in SMEs are:

- (a) the companies' object/activity must be to invest in SMEs;
- (b) they must invest at least 75% of their qualifying assets in certain financial instruments that provide financing to SMEs (e.g., shares, securities, participative loans, etc.); and
- (c) they may invest up to 40% of their qualifying assets in a single company and up to 40% in companies of the same group (broadly, this limit is 25% and 35%, respectively, in the case of private equity funds/companies that do not qualify as FCRs-PYME or SCR-PYME).

### 2. Do funds need to be licensed by any regulatory authority to conduct business in Spain?

After the implementation of the EU Alternative Investment Fund Management Directive (**AIFMD**) in Spain, the general rule is that funds need to be licensed to conduct business in Spain. Further, Spanish regulated entities must obtain the approval of the Spanish Securities Market Commission (**CNMV**) before commencing operations. The approval process varies in complexity and time depending on the type of entity chosen.

As mentioned above in question 1, FCRs must be managed by a regulated third party that acts as a management company. These entities are regulated by the CNMV. Management companies (as well as self-managed SCRs) must have:

- (a) sound administrative and accounting organization, sufficient human and material resources, adequate internal management and risk control and prevention of money laundering procedures in place; and
- (b) an internal code of conduct.

Further, all directors, executives and managers of the management company must have a recognized commercial, business and professional reputation, and the majority of the directors, general managers and executives must have sufficient level of knowledge and experience in financial matters or business management.

### 3. Are there any approvals required for investments by foreigners in Spain and, if so, what is the process?

#### Prior authorization

With the exception of certain sectors (air transport, radio, television, gambling, telecommunications and national defense), prior governmental authorization is not required for foreign investments in Spain. Following completion of any investments in Spain, however, non-residents must notify the authorities of the investment for statistical purposes (see below). Likewise, investments and disinvestments out of Spain by Spanish resident investors must also be notified. This monitoring does not unduly hinder or delay an investor's freedom to make payments or to transfer currency or other assets. It should be noted, however, that Spanish authorities are also entitled to request reasonable information relating to a transaction and to require that the relevant payments or transfers are carried out through licensed financial institutions.

#### Notification requirements

The Spanish General Directorate of Economy and Trade (*Dirección General de Comercio e Inversiones*) must be notified of the following foreign investment proposals following completion of the investment:

- (a) participation in Spanish companies, including incorporation, share purchases, capital increases or any other operation resulting in a participation in the share capital of, or the acquisition of rights in, a company (e.g., subscription of rights over future shares);
- (b) the incorporation of a Spanish branch or an increase in its funds;
- (c) the acquisition of transferable securities represented by the issuance of debt by a Spanish resident or company;
- (d) participation in investment funds recorded with the Spanish Stock Exchange Commission (*Comisión Nacional del Mercado de Valores*);
- (e) purchase of real estate property located in Spain valued at EUR 3,005,060.52 or more, or any other amount if the investment originates from a tax haven (as listed in Royal Decree 1080/1991); and
- (f) other forms of investment (e.g., foundations, community property, etc.) amounting to at least EUR 3,005,060.52, or any other amount if the investment originates from a tax haven (as listed in Royal Decree 1080/1991).



The notification must comply with certain requirements set out below and must be executed by filing the corresponding form.

When the investment originates from a tax haven, prior notification of the investment must be given in addition to any subsequent notification (explained below) required for any other foreign investment. As an exception, prior notification is not required for an investment carried out by means of an acquisition of listed shares or when the foreign participation does not reach 50% of the Spanish company.

Notification is generally for information and statistical purposes (although the tax authorities may use the information for tax collection purposes). The notification does not limit the ability of the foreign investor to remit income outside of Spain, where it is derived from the investment, or proceeds of any subsequent divestment about which notification must also be made.

As a general rule, with a few exceptions, a foreign investment in Spain must be legalized by means of a document executed before a Spanish notary public by the non-resident investor and notification must be made to the General Directorate of Economy and Trade. The Spanish notary public can also file the notification on the corresponding form. Before doing so, however, the investor must evidence that:

- (a) it has obtained relevant administrative consents or clearances;
- (b) the foreign contribution has taken place; and
- (c) it is not a resident of Spain.

Where the contribution is a transfer of funds, a bank certificate should be obtained. Once the foreign investment is legalized, the form must be presented for registration at the General Directorate of Economy and Trade of the Ministry of Industry, Tourism and Trade for registration.

#### 4. Who are the relevant regulators in Spain and how much interaction one would generally expect when undertaking a buyout?

The principal regulatory bodies in Spain are:

- (a) the Securities Market Commission (**CNMV**) - the supervisory body for, among others, the stock exchange, securities, investment firms and collective investment institutions;
- (b) the Central Bank of Spain - supervises investments in banks, credit institutions and other financial intermediaries (including anti-money-laundering obligations);
- (c) the National Markets and Competition Commission (**CNMC**) - a new authority which merges the competition authority with sector regulators responsible for telecommunications, energy, railway, postal, audiovisual and airports;
- (d) the General Directorate of Insurance and Pension Funds (**DGSFP**) - the supervisory body for, inter alia, insurance and reinsurance companies and insurance intermediaries; and
- (e) the tax authorities.

Depending on the features of the buyout, the intervention of regulators may be required and, eventually, can be very intense (e.g., if the target of a buyout has its securities admitted to trading on an official exchange, the takeover bid must be approved and the prospectus verified by the CNMV).

Further, if a leveraged buyout gives rise to a 'concentration' and certain relevant thresholds established by Spanish or European law (in terms of turn-over and/or market share) are exceeded, the transaction is subject to the prior approval of the CNMC. This is often the case in large buyouts.

## 5. How are buyouts typically undertaken in the private and the public markets?

### Private companies

Acquisition of private companies can be the result of bilateral negotiations, in so-called ‘private deals’, or can be conducted through an auction (or competitive process). The latter is the most frequent scenario in recent times and tends to maximize the price for the seller but gives rise to certain agency problems with regard to management neutrality. In a buyout of a private company, the potential acquirer always requires the performance of full due diligence reviews before submitting a final offer.

### Public companies

The acquisition structure for a public company buyout is more complex than in a private context. Under the Spanish securities legislation, a change of control is deemed to occur when, as a result of the deal, the buyer acquires more than 30% of the voting rights in the target company or the buyer becomes able to appoint more than half of the members of the target company’s board of directors. A buyout offer over a publicly traded company that meets these criteria would typically require the launch of a mandatory takeover bid.

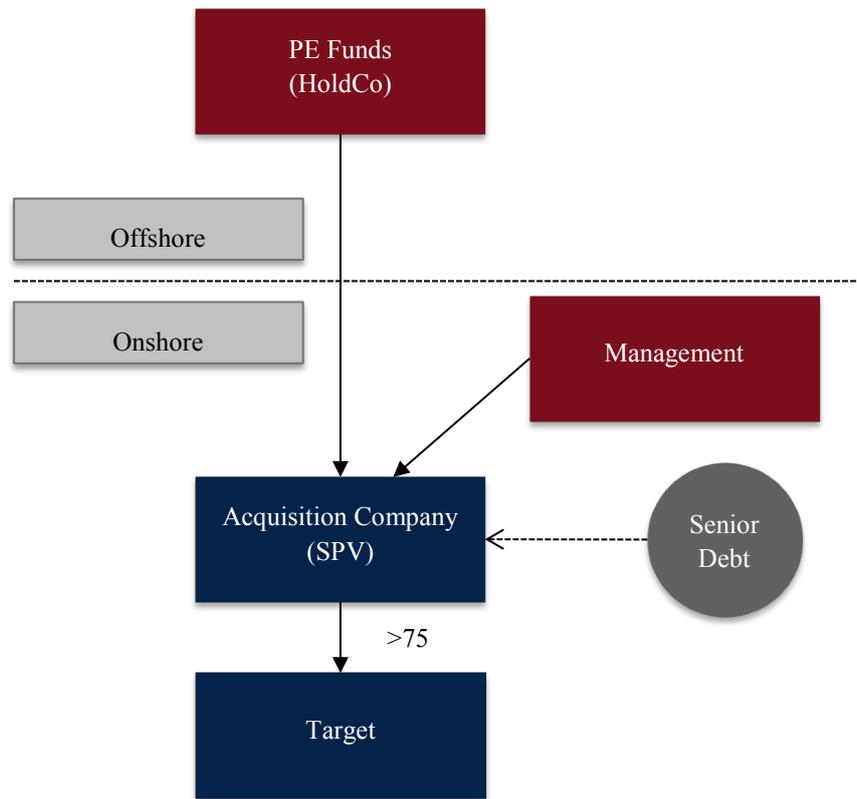
This takeover process is heavily regulated. It requires a prospectus to be filed with the CNMV explaining the details of the offer. In particular, it is mandatory to announce whether it is the intention of the offeror to delist the shares in case of success, the financial means used to carry out the acquisition and the eventual impact on the leverage of the target company (all of which are relevant items in a buyout). Mandatory bids must be addressed to all holders of the target company’s shares, and all holders of the target company’s convertible bonds or share subscription rights.

Further, Spanish regulated private equity entities cannot invest in a public company unless they do so with the intention of de-listing the public company’s shares from the exchange. The Spanish Securities Act provides for a ‘squeeze-out’ mechanism that allows for the compulsory sale of minority shareholdings if the offer reaches certain qualified thresholds of success (90% of the voting rights in the target company and 90% acceptance among securities which were the object of the offer).



## 6. What is the typical corporate structure used when doing a buyout?

A typical structure is along the following lines:



The corporate structure varies depending on a number of circumstances (e.g., whether there is a local or foreign investor, the sophistication of finance sources, whether there is a public or private target and tax considerations). Large buyouts are typically carried out through a holding company (HoldCo) incorporated abroad (with Luxembourg being the jurisdiction of choice) and a special purpose acquisition vehicle (Acquisition Company SPV) incorporated in Spain (typically in the form of a limited liability company). Management participation is usually taken at the Acquisition Company/SPV level.

The most common scheme is for there to be a post-acquisition merger of the Acquisition Company SPV with the target company within a maximum two-year period, in order to push down the debt and to avoid financial assistance issues. Note that in those cases where there is a post-acquisition merger, the acquisition by the Acquisition Company SPV of a 75% minimum participation in the share capital of the target company is required for the Acquisition Company SPV to be allowed to obtain tax consolidation with the target.

When the target is a listed company, the structure can be extremely complicated, in part to neutralize the effect of the eventual remaining free float if the squeeze-out thresholds are not attained (i.e., minority shareholders that do not accept the takeover bid offer). In these cases, two, three and even four-tier structures are often used with senior debt finance being taken at the highest level (HoldCo) and subsequently contributed down through the layers of SPVs to the Acquisition Company in the form of unsecured shareholder loans.

Spanish Corporate Law provides for a wide range of company types. SPVs are typically incorporated as limited liability companies, either in the form of:

- (a) limited liability companies (*sociedades de responsabilidad limitada*) (**SRL or SL**); or

- (b) a corporation (*sociedades anónimas*) (SA).

## SRL/SL

In contrast to SAs, SRLs were originally conceived for small or family-owned companies where trust and personal relationships are the founding principles. For this reason, the legal structure and operational mechanisms of an SRL are less sophisticated and in general, more flexible than those of an SA. That being said, Spanish corporate law imposes significant restrictions on the transfer of quotas of SRLs and the statutory voting requirements are more stringent than those applicable to an SA. Nowadays, most of the Spanish subsidiaries of multinational companies adopt the form of SRLs.

## SA

An SA is a corporate structure mostly designed for large corporations that require the availability of control mechanisms or sophisticated legal structures. Listed companies or companies which must comply with investment regulations must take the SA form.

An SA may adopt special rules to call meetings, meet the minimum quorum or set voting rights. Operationally, therefore, the SA resembles a typical U.S. corporation. The minimum capital required to incorporate an SA is EUR 60,000 of which at least 25% must be paid-in on incorporation. Payment of the outstanding portion of capital must be carried out as indicated in the corporation's bylaws.

## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

Typical corporate pre-contractual documents are non-disclosure and confidentiality agreements, letters of intention, memoranda of understanding, preliminary non-binding offers and so-called 'final offers' that, in practice, are heavily conditioned.

In addition, contractual documentation may include the following:

- (a) co-investment agreement where there are several private equity houses or institutional investors bidding together. It is also sometimes referred to as a subscription agreement and it regulates the equity and loan contributions of the sponsors, co-investors and managers (in a management buyout) at the Acquisition Company SPV level;
- (b) shareholders agreement that provides for the rights and obligations of the shareholders of the Acquisition Company SPV and the target, as well as the governance of the Acquisition Company SPV (including provisions in relation to disposal and encumbrance of shares, exit rights and generally regulation of the relationship among the shareholders during the life of the investment). The shareholder agreement can also regulate the relationship with the managers in the absence of a specific management agreement;
- (c) management agreement that typically sets out the incentives granted to the managers (e.g., ratchets, options, etc.), good leaver and bad leaver provisions, as well as management's general obligations (e.g., exit facilitation, liability for warranties, undertakings to remain after the exit); and
- (d) sale and purchase agreement which is the key document regulating the acquisition of control over the target company.

### Banking

Finance documents can vary greatly depending on the sophistication of the acquisition package. In the pre-contractual phase of the transaction, term sheets can be negotiated with financial institutions. High



yield bond issuances have been very rare in Spain. Sometimes a bridging loan is put in place to speed up the acquisition process and is subsequently replaced by the senior facilities. This is often the case for a buyout of a public company.

The most typical banking documents are:

- (a) a senior debt loan agreement that is usually negotiated with a leading bank and subsequently syndicated in some cases;
- (b) securities deeds for the creation of pledges and mortgages over shares of the target company (usually taking place on closing of the transaction) while security over the underlying assets is created post-acquisition. The execution of the relevant deeds requires substantial negotiation and drafting in Spain to satisfy the banks' requirements; and
- (c) a separate mezzanine facility and intercreditor agreement if subordinated debt is obtained.

Vendor loans are rarely used in Spain. When they are used, their provisions must be disclosed to the senior lenders to evidence the absolute subordination of the vendor loan to that of the senior lenders.

## 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

Post closing price adjustments are usually accepted by sellers on the basis of a closing accounts verification, due to net debt or working capital variations between signing and completion.

For family owned or traditional companies, often run by founders, protection is often sought from sellers in the form of representations and warranties. Where there is a clear separation between ownership and management (e.g., in the case of a secondary buyout) that protection is usually much more limited. It is however very infrequent in practice for the seller not to give any warranties at all. Tax and social security obligations are usually guaranteed for a certain period (statute of limitation period) due to the high uncertainty involving their assessment by the authorities. However in secondary buyouts in which the existing management remains involved, representations and warranties are typically given by the managers, more as a deterrent against a negligent lack of disclosure than as an effective economic protection.

In the case of publicly listed companies, only those controlling shareholders reaching a particular agreement with the bidder, outside the regulated takeover procedure, may give some basic warranties in relation to very specific aspects of the company or the underlying business. Payment of break-up fees by listed companies in takeover bids was expressly regulated for the first time in a 2007 amendment of the Spanish takeover regulations.

The liability of the seller is usually limited in time and to a certain amount, including claim thresholds and caps. The most common mechanisms to secure payment of indemnification obligations are either placing a portion of the price in escrow or delivering bank letters of guarantee to the purchaser. Both forms can be foreclosed if a contingency arises.

The use of representation and warranty insurance policies as a way to provide protection to buyers and security to sellers is gaining popularity (albeit still relatively rare and expensive).

## 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

There are no specific laws regulating how conflicts of interest of managers should be dealt with in a management or buyout in Spain.

However, there is a statutory obligation under Spanish law to act in good faith during negotiations, which for managers involved in a management buyout implies that they must not wrongly use their

corporate position to obtain a personal advantage. Management may also be in a position of conflict due to the contractual obligations they owe to the target company under any service agreement. Furthermore, if a manager is a director, the Companies Act (*Ley de Sociedades de Capital*) (**Companies Act**) provides that directors of companies, private or public, are bound by a duty of loyalty to the corporate interest, which is understood to be the interest of the corporation itself. No fiduciary duty to shareholders exists, but when there is a single shareholder, the doctrine tends to identify the shareholder's interest with that of the corporation. Managers who are not directors should not disrupt their dedication to the company's business in a buyout situation. The use of 'management protocols' to address these issues is not common in Spain.

Note that when dealing with public companies, the managers must abide by the 'passivity' rule set out in the Securities Act that prevents them from doing anything that might hinder the success of a takeover bid. Additionally, where several tender offers are submitted, management should grant equal disclosure treatment to all bidders.

## 10. How are the equity arrangements typically regulated in a buyout?

Spanish corporations law is relatively flexible in relation to equity arrangements. In a buyout, these are implemented by way of a shareholders agreement entered into by the Holdco/Acquisition Company/SPV and the fund or funds providing the equity, and, to the extent permitted, incorporated in the company's articles of association and bylaws. (Ideally, to improve effectiveness of shareholders agreements, the provisions should be replicated in the articles of association that must be filed publicly. Note that in some cases, the specific provisions contained in a shareholders agreement may exceed the accepted content for articles of association and these would normally not be replicated in the articles).

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

Spanish law expressly provides for the possibility of having different rights attached to different classes of shares. In leveraged buyout transactions it is not uncommon for the Acquisition Company/SPV to issue a class of preferred shares to be held by the private equity fund.

Some of the rights most commonly attached to a preferred class of shares are:

- (a) pre-emptive rights in the case of the transfer of shares;
- (b) tag-along and drag-along rights;
- (c) a right to appoint members of the board;
- (d) a right to a preferred dividend;
- (e) anti-dilution rights;
- (f) preferential subscription rights;
- (g) liquidation rights;
- (h) conversion into common shares; and
- (i) registration rights in the event of an IPO.

It is also possible to have different voting rights and, in some instances, different economic rights (e.g., dividend and liquidation preference rights) attaching to different classes of shares.



## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

The Companies Act allows substantial freedom for companies to regulate the composition and functioning of the board of directors. In the absence of specific provisions in the constitutional documents of a corporation, the shareholders have a ‘right of proportional appointment’ to elect directors *pro rata* to their stake in the share capital. Re-enforced quorum and super-majority votes at board level are permissible although a unanimous vote requirement under the articles of association is not. In practice, unanimity is often required in the shareholders agreement for more significant decisions.

When the buyout is carried out by a consortium of financial investors, if some of the existing shareholders remain or if the transaction is a management buyout, the relevant shareholders agreement usually sets out the composition of the board of directors at the level of the Acquisition Company/SPV and/or the target.

## 13. What measures are commonly used to give a private equity fund some level of control over key operating and financial decisions made by a portfolio company?

Control measures relating to the composition and operation of the board of directors are generally set out in the articles of association or in the shareholders agreement to ensure that the private equity fund has the appropriate preferred rights and therefore acquires a degree of control over the investee company (which may be disproportionate to their shareholding). The shareholders agreement may also set out a list of ‘reserved matters’ (generally including key operating and financial decisions, such as the approval or amendment of the business plan and annual budget) which require a special resolution and/or an affirmative vote of the directors appointed to the board by the private equity fund. In addition, the fund usually has specific information rights (e.g., the right to receive detailed information on the financial situation of the operating companies) as well as the right to appoint the statutory and/or internal auditors.

## 14. What employment terms are generally imposed on management in a buyout?

Senior management is usually offered the opportunity to enter into senior-level executive employment agreements that are governed by a Royal Decree and enjoy slightly less protective conditions than, for example, those imposed by the Spanish Workers’ Statute. Ordinary employees under the Workers’ Statute enjoy, among other things, a more favorable regime of working time, including entitlements to overtime payment, and they also benefit from higher statutory severance compensation in the case of dismissal.

Alternatively, the managers may be more interested in the execution of a services (non-employment) agreement, but attention must be paid to the true nature of the relationship for labor and tax reasons. The most salient issue to take into account when doing a management buyout in Spain is that Spanish labor laws are extremely protective of employees’ rights (even key employees holding executive offices) and very expansive in the sense that the courts tend to apply those laws even to service contracts formally excluding their applicability.

The employment agreement usually provides for total devotion of time to the company management and post-contractual non-competition and non-solicitation obligations. Incentives are usually granted in several forms, such as variable remuneration, bonuses, and fringe benefits, as well as equity participation.

## 15. What equity incentives can be offered to management and how are they typically structured?

Equity incentives are consistently offered to senior management and normally provided for in the shareholders agreement, unless a specific management agreement is executed. The extension of any incentive of this type to other employees is left to the discretion of the senior executives (bearing in mind that the final decision will be agreed and passed at the level of the general shareholders meeting).

Theoretically, the equity incentives can be structured in many different ways but, in practice, the implications of Spanish tax and labor laws tend to make simple stock option plans more advisable than sophisticated schemes, because tax treatment does not provide for much flexibility. As a general rule, stock options entailing an acquisition price below market value are taxed in respect of the difference as ‘salary-in-kind’ (i.e., personal income), but if the option is exercised after a two year waiting period the remuneration is deemed to have accrued during that period and is considered ‘long term’ income (rather than ‘current compensation’), therefore enjoying a more favorable rate. On the sale of the shares, any profit made is taxed as capital gains at flat rather than at progressive rates.

Any company stock held by managers is subject to a call-option exercisable by the private equity fund in the event that the manager is terminated. Good and bad leaver provisions are usual, but the application of labor law can distort the parties’ agreements.

Another mechanism used in buyouts is ‘ratchets’. These are agreements to adjust the direct equity participation of the management upwards or downwards depending on the performance of the company (or the manager), so that at exit of the investment, the managers are entitled to acquire (or sell, it depends on the type of ratchet) from the fund, at no cost, an additional amount of shares which apportions to them a greater stake in the sale proceeds. The tax treatment of this incentive is not completely clear under applicable Spanish regulations, since the sale of the additional shares is taxed as capital gains but the right to acquire them at no cost could also be considered a kind of remuneration for the work performed (and therefore taxed at a higher rate). However it is the fund, rather than the target company or the management that bears the cost.

Another mechanism also used is a ‘carried interest’ regime when the fund/investor is a private equity fund/company. ‘Carried interest’ regimes are put in place through relatively complex structures designed by tax specialists. They normally involve participation by the private equity fund managers as equity holders at some level of the investment structure, so that their participation in profits can obtain a more favorable tax treatment, by considering their share of the profits as something other than pure employment compensation (which is subject to higher taxation). (Note, however, that tax authorities have recently questioned some of these structures and treated the profits obtained by private equity fund managers as employment compensation.) Carried interest can be structured in many different ways but, in practice, the most common are either by privilege shares (to which privileged economic dividends rights attach) and by employment agreement incentives. On obtaining the ‘carried interest’, any profit made is taxed as proceeds of investment (capital gains) at flat rates (by the way of privileged economic dividends rights, taxed at 20/24% in 2015 and 19/23% in 2016) or progressive rates (by the way of employment incentives, taxed as a general rule, up to 47% in 2015 and up to 45% in 2016 onwards).

## 16. How are buyouts typically debt financed and secured?

Buyouts are typically financed through a mix of sources, including senior loans, mezzanine debt, subordinated loans and equity. The amount of debt raised is typically calculated as a multiple of the target EBITDA or other financial ratios.

Senior lenders request a clear subordination of any debt owed to mezzanine providers, sellers or shareholders. This can be achieved in several ways (e.g., by entering into an all-parties intercreditor



agreement or by means of a structural subordination so that the different types of debt are lent at different levels throughout the corporate structure).

Senior debt is typically secured with charges (pledge/mortgage) over the shares of the target company and over its assets, including assignment of credit rights arising from the contractual documents of the deal (e.g., warranties and indemnities). Compliance with the strict financial assistance provisions of Spanish law must be taken into account.

When undertaking a buyout of a public company, the financing arrangements are more sophisticated in relation to ensuring the banks' commitment. The takeover regulations provide that a bidder should not announce an offer until it has sufficiently assured the availability of means to fully discharge its obligation of payment of the offered consideration.

## 17. Are there financial assistance issues to consider when undertaking a buyout?

### Financial assistance prohibition

Under Spanish corporate law, it is unlawful for a company to provide financial assistance to facilitate the acquisition of its own shares or the shares in its parent company. It is also unlawful for an SRL or SL, as further explained below, to facilitate the acquisition of shares in other group companies. Transactions carried out in breach of this prohibition are null and void under the Spanish Civil Code. The aim of this prohibition is to avoid target companies assuming the acquisition debt to the detriment of minority shareholders, creditors and other interested third parties.

### Companies Act

This prohibition is regulated under Section 143.2 of the Companies Act for Private Companies and under Section 150 of the Companies Act for SAs (**Public Companies Act**). The wording is intentionally broad to capture any kind of financial aid granted by a company to facilitate the acquisition of its own shares, the shares of its parent company or, if applicable, the shares in other group companies.

Section 143.2 of the Companies Act states:

'Private limited liability companies may not advance funds, grant loans, guarantees or security, or provide financial assistance for the acquisition of their own shares or shares issued by any company belonging to their group.'

On the other hand, Section 150 of the Companies Act states, in its first paragraph:

'Public limited liability companies may not advance funds, grant loans, guarantees or security, or provide any type of financial assistance for the acquisition of its shares or its parent company's shares by a third party.'

A Spanish company may however guarantee or secure the payment obligations arising from any tranches of the acquisition facility or any additional facilities granted to finance purposes other than the acquisition price, costs and expenses, such as the refinancing of pre-existing indebtedness of the target or target group (to the extent that that indebtedness does not qualify as acquisition debt), working capital requirements and future investments. The prohibition in Section 150 does not apply to the acquisition of shares by the company's employees nor to transactions carried out by banks and other financial institutions conducted within the ordinary course of business.

## Regulations on certain merger processes

Section 35 of Act 3/2009 specifically regulates merger processes in which one of the companies involved in the merger has obtained financing during the three preceding years to acquire the shares or assets of another company also involved in the merger process.

Section 35 of Act 3/2009 states:

‘In mergers involving two or more companies, where one of them incurred debt in the three years immediately preceding the merger to acquire control of another or to purchase assets thereof essential to its normal operations or of importance for the value of its equity, the following rules shall apply:

- (i) the merger project must specify the resources and dates on which the resulting company is expected to repay the debts incurred to acquire control of the assets;
- (ii) the directors’ report on the merger project must specify the reasons justifying acquisition of control or the assets as well, as appropriate, as the merger operation. It must also contain an economic and financial plan listing the resources and a description of the objectives sought; and
- (iii) the experts’ report on the merger proposal must contain an opinion stating whether the items referred to in the two preceding items are reasonable and determining the possible existence of financial assistance. Under the circumstances referred to in this article, the expert report shall be requisite, even when the merger agreement is unanimously adopted.’

Although this section was meant to bring certainty to leveraged mergers by expressly allowing them under certain circumstances (in line with the 2006 amendment to the EU Second Directive), the wording of Section 35 leaves the matter unclear. Section 35 of Act 3/2009 requires that, in the case of a leveraged merger, certain information must be included by the directors in the merger project and the directors’ report. It also requires that an independent expert must issue a report stating whether the information included in the merger project and the directors’ report is reasonable and confirm whether there is financial assistance. However, Section 35 remains silent about the consequences if the independent expert’s report concludes that there is financial assistance and/or that the information contained in the merger project and/or the directors’ report is not reasonable. Further, Section 35 does not expressly state that a clean independent expert’s report concluding that there is no financial assistance and that the information contained in the merger project is reasonable amounts to a successful ‘whitewash’ procedure in relation to the relevant merger and that, consequently, the risk of unlawful financial assistance and its various consequences may be clearly disregarded.

In view of the above, obtaining a clean report from an independent expert that concludes that the information included in the merger project and the directors’ report is reasonable and stating that the merger does not involve financial assistance is a key step to be able to carry out the leveraged merger. This, in turn, implies that it will not be possible to know upfront if the merger process can be completed and it will be necessary to wait until the report of the independent expert is finally issued to make that determination.

Section 35 of Act 3/2009 has been heavily criticized for wrongly imposing on auditors and financial experts the duty of interpreting a purely legal issue such as the potential existence of unlawful financial assistance. There are few precedents of leveraged mergers registered after the enactment of Act 3/2009 and the full text of the independent experts’ reports are not publicly available at the Commercial Registry.

However, it is reasonable to expect that independent experts will not provide a legal analysis in relation to the existence of financial assistance (as they do not have the necessary legal expertise to do so). They will instead provide a financial analysis (similar to the one provided when issuing reports on financial statements) of the information provided by the directors in the merger project and the



directors' report. This financial analysis will assess whether it is reasonable to conclude that the resulting company will be able to generate sufficient cash flow (from ordinary operating revenues and other sources such as tax credits, divestment of certain assets or recourse to other financial resources) to repay the debts (including the acquisition debt) when they fall due without negatively affecting the ordinary course of the surviving company's business due to overindebtedness or illiquidity which could lead to an insolvency situation.

## Penalties for breach

In addition to the nullity of transactions carried out in breach of the financial assistance prohibition, a breach may be sanctioned by the imposition of a fine of up to the par value of the shares acquired with financial assistance. A breach may also attract directors' liability under Section 157 of the Companies Act. For these purposes, Section 157 considers 'directors' to be, not only the members of the board of directors, but also the company's managers (*directivos*) and representatives (*personas con poder de representación*). Directors of the parent company inducing the breach of the financial assistance prohibition by the subsidiary may also face liability in accordance with Section 157 of the Companies Act.

## 18. What are the implications under the corporate benefit laws of Spain for a company providing financial assistance?

In Spain, the concept of corporate benefit relates to the fiduciary duty of diligence and loyalty imposed on directors under Sections 225 and 226 of the Companies Act. These sections provide that directors of a company must always perform their duties with the diligence of an orderly businessman and must act as loyal representatives, in defense of the corporate interest, which is interpreted as the interest, or the benefit, of the company.

When considering providing any aid for the acquisition of the company's shares or the shares issued by any company belonging to its corporate group (in the case of a private company, i.e., an SRL or SL) or the shares issued by its parent company (in the case of an SA), the directors of the assisting company must act in the interest of that assisting company.

In the absence of one or more managing directors with broad powers, the granting of security/guarantee by a Spanish company will require a board of directors' resolution (unless the management body of a company is, for example, a sole director). If the security/guarantee is to be granted by a private company to secure/guarantee obligations incurred by its shareholders or directors, a shareholders' resolution approving the granting of the relevant security/guarantee would also be required.

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

The Spanish Insolvency Act classifies debts on the basis of their ranking, as privileged, ordinary, and subordinated the details of which are set out below.

### Privileged claims

Privileged claims are, in turn, divided into 'special' and 'general' privileges.

Creditors with a special privilege bind specific rights and goods of the debtor to the discharge of the corresponding debt. A creditor with special privileges may enforce its claim separately. These claims are those secured by rights or securities (e.g., mortgages and pledges). Claims with general privilege affect all of the debtor's assets. They enjoy a preferred rank compared to ordinary ones, and will be paid only after the claims with special privilege have been deducted. Employees' salaries and tax or social security duties, for example, are in this category.

## Ordinary claims

Ordinary claims are equivalent to unsecured claims. They are those claims that are not expressly qualified by law as privileged or subordinated. They are payable only after the privileged claims have been paid. In an insolvency procedure, unsecured creditors rank with equal rights and privileges and are paid in the same proportion. Payment time schedule and proportional reductions for each creditor are agreed and confirmed by the courts.

## Subordinated claims

Subordinated claims are those payable after the privileged and ordinary claims have been discharged. A shareholder holding more than 10% of the share capital of a company (5% if the company is listed) will automatically qualify as a subordinated creditor in an insolvency. Likewise, group companies and directors (both *de jure* and *the facto*) of the insolvent company will also be considered to be subordinated creditors. Subordinated creditors are not entitled to vote at the creditors' meeting that would be held in the event that a proposal for a creditors' arrangement is put forward.

After the recent amendment to the Insolvency Act (by Royal Decree-act 11/2014, September 5, 2014), creditors who have acquired their claim after the commencement of insolvency proceedings are entitled to vote at the creditors' meeting, unless they qualify as subordinated creditors (in which case they do not have the right to vote).

Further, any creditor (including secured creditors) may be bound by the terms of the creditors' arrangement, if certain majorities are met (and even if the relevant creditor has expressly voted against that arrangement).

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

Tax issues generally affecting buyouts and foreign investors in particular can be summarized as set out below.

### Taxes at the fund level

The structure used will determine the overall tax treatment of the investment. When the funds are funneled through a Spanish tax resident vehicle, the investment will be subject to domestic rules.

Direct investments by a non-resident entity invoke domestic tax rules on non-resident companies and require verifying whether those rules are superseded by any tax treaty signed by Spain to avoid double taxation. Non-resident entities directly holding a stake in Spanish companies are not automatically deemed to have a permanent establishment in Spain.

European tax-resident investors benefit from specific tax benefits in relation to interest, dividends and royalties payments.

### Stamp duty/transfer taxes

No stamp duty or VAT is levied on the transfer of shares. However, there is an anti-abuse provision for real estate companies which provides that the acquisition of control in entities, the assets of which are comprised mainly of real estate property not used for economic activities, are subject to transfer tax in the same manner as the transfer of the assets themselves (varying from 6 to 7%, depending on the region).



## Income tax

### *Spanish corporate income tax*

Under the Tax Reform Acts, the general tax rate has been lowered from 30% to 25%. However, this reduction is gradual. Therefore, in Fiscal Year 2015, the rate will be 28% and will reach 25% starting in 2016.

### *Spanish tax-resident individuals*

According to the changes approved by the Tax Reform Acts, the applicable to savings income (dividends, interests and capital gains) tax rate for Spanish tax-residents will decrease to 20-24% in 2015 and to 19-23% from 2016.

### *Non-Spanish tax residents*

According to the changes approved by the Tax Reform Acts, the applicable rate for savings income (dividends, interests and capital gains) will decrease to 20% in 2015 down to 19% from 2016.

## Capital gains tax

Capital gains realized on exit are taxed irrespective of the short/long term accrual of the gain<sup>33</sup>. There is a favorable tax treatment afforded by Spanish legislation to regulated private equity entities. Venture capital companies enjoy a 99% exemption on capital gains from the sale of shares held for at least one year in eligible entities. No exemption is granted after a holding period of 15 years (that period can be extended to 20 years on request).

For exits by non-resident investors, capital gain taxation may be triggered and requires careful planning. Capital gains can be tax-exempt for European Union tax-resident investors to the extent that certain requirements are met.

Double tax treaties signed by Spain provide specific rules. In this regard, non-resident investors that can benefit under a double tax treaty will generally be subject to capital gains tax in respect of companies with assets which directly or indirectly consist principally of real estate property, at the rates described above.

## Deductibility of interest and financing costs

As a general rule, expenses accrued by Spanish tax-resident entities to finance an acquisition is tax-deductible. However, related intercompany financial transactions require prior analysis to determine whether their terms can be considered to be entered into on an arm's length basis.

The following restrictions apply in relation to deductibility of interest expenses:

- (a) interest related to debts generated within a corporate group in order to acquire participations in the capital or equity of any kind of entities from other group entities, or to make capital or equity contributions to other group entities, is not deductible. However, note that the restriction does not apply if the taxpayer can provide evidence of the existence of valid economic reasons for the underlying transactions; and
- (b) net interest deductions are generally capped at 30% of the tax-adjusted EBITDA. However, in any case, net interest expenses are considered tax deductible if they do not exceed EUR 1 million per year.

New financial expense limitations impacting buyouts were introduced by the Tax Reform Bills by which an additional limit of 30% of the operating profit for financial expenses derived from debt

<sup>33</sup> For the 2014 tax year, short-term capital gains obtained by Spanish tax resident individuals are taxed at the marginal rate. This provision is eliminated under the provisions of the Tax Reform Bills.

granted to purchase stakes in any type of company applies. The idea is to limit the traditional offsetting of financial expenses derived from debt to acquire a target company with the profits of the target company through a merger or restructuring process or applying a consolidated tax group regime. This limitation is not applicable however in the year of acquisition if the debt does not exceed 70% of the acquisition price, nor in the subsequent years if the debt is reduced on an annual basis by 5%, until reaching 30% of the acquisition price.

## Withholding tax

For non-resident investors, withholdings are relevant to the extent that returns will be repatriated by way of dividends or interest.

According to the changes in the Tax Reform Acts, in relation to dividend payments, a general withholding rate applies both for resident and non-resident entities (20% for 2015 and 19% for 2016 onwards). Special tax rules allow tax-exempt dividend payments to non-resident investors if certain requirements are met. European Union resident investors may benefit from the Parent-Subsidiary Directive exemption. Finally, double tax treaties signed by Spain provide for a reduced tax withholding rate.

## 21. What forms of exit are available?

For mid-capitalization companies the most common form of exit route is via a trade sale to a strategic buyer, either through a bilateral negotiation or through an organized ‘auction’ process. A sale to another private equity fund (known as a secondary buyout) has also become more frequent. For larger companies or after a successful build-up process, an IPO is another exit alternative.



## Sweden

### 1. What structures do private equity funds typically use to manage their funds?

The principle structures that may be used for private equity funds in Sweden are set out below.

#### Swedish limited liability company

There are two categories of limited liability companies, private and public. A private limited liability company is the more common of the two forms. The major difference between the two categories is that only public limited liability companies may offer shares and other securities to the public. A private limited liability company may not introduce its shares on the stock exchange or on any other organized market.

#### Swedish limited partnership

A limited partnership consists of one or more limited partners and at least one general partner. A limited partner does not, under the provisions of the Swedish Act Governing Limited Partnerships, have any obligation for debts and liabilities of the limited partnership in excess of the amount that it has committed to the limited partnership. The general partner is solely responsible for the limited partnership's debts and liabilities that exceed the responsibility of the limited partners. The limited partnership is tax transparent and therefore the partners are taxed directly for the income of the limited partnership.

#### Swedish consortium

The investors invest directly and in parallel in the investee company. This structure could be advantageous for its favorable tax treatment for capital gains, and dividends may be achieved for investors who enjoy favorable tax treatment in Sweden for capital gains and not for business income.

#### Foreign company

A non-resident private equity investment company is not liable to pay Swedish tax on capital gains made in respect of Swedish assets, unless it is deemed to have a permanent establishment in Sweden. Since July 2013, Swedish securities funds are not taxed on their income from the assets in the fund. Therefore, private equity companies that were previously forced to adapt foreign fund structures so that foreign investors were not forced to pay additional tax (as they would have been if they are deemed to have a permanent establishment in Sweden), are no longer forced to do so.

#### Foreign limited partnership

Many Swedish private equity funds structure their funds as a partnership, regulated by English law. The investors hold limited partnership interests in the partnership and there is a general partner that takes day-to-day management control of the partnership and its operations. It is also common to use a Luxembourg or Netherlands structure.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in Sweden?

Funds are not required to be licensed by any regulatory authority to conduct business in Sweden. The manager of the fund, however, in many cases must comply with rules originating from the EU Alternative Investment Fund Managers Directive (**AIFMD**) as implemented in Sweden. These rules, among other things, require the manager to seek a license for its business or, alternatively, to apply for registration if the total assets under management are less than EUR 100 million.

### 3. Are there any approvals required for investments by foreigners in Sweden and, if so, what is the process?

There are no special approvals required for investments by foreigners in Sweden.

### 4. Who are the relevant regulators in Sweden and how much interaction would one generally expect when undertaking a buyout?

The primary regulatory authorities in Sweden in a corporate context are:

- (a) Swedish Companies Registration Office (*Bolagsverket*) - registers new companies as well as changes in established companies, receives annual accounts, registers corporate mortgages, makes decisions in relation to liquidations and makes the information in the trade and industry registers publicly available;
- (b) Swedish Tax Authority (*Skatteverket*) - the administrative authority for taxation, national registration and inventory of property;
- (c) Swedish Financial Supervisory Authority (*Finansinspektionen*)- the public authority responsible for financial supervision including promoting stability and efficiency in the financial system, and authorizing, supervising and monitoring all companies operating in the Swedish financial markets. This regulatory body also oversees AIFMD registration and filing;
- (d) Nasdaq Nordic Exchange - the major Nordic stock exchange that serves as an open gateway to the Nordic and Baltic financial markets, promoting greater interest, opportunity and investment in the whole region; and
- (e) Swedish Competition Authority (*Konkurrensverket*) - actively prevents harmful restrictions on competition for the benefit of consumers.

The level of involvement by the Financial Supervisory Authority and Nasdaq Nordic Exchange depends on whether or not, for example, the transaction is being undertaken in respect of a publicly listed company.

Interaction with the other authorities largely depends on the nature of the transaction and the parties involved (e.g., if the buyout involves competition/antitrust issues or the registration of complicated issues of new shares with the Swedish Companies Registration Office).

### 5. How are buyouts typically undertaken in the private and the public markets?

#### Private context

In a private context, transactions are usually undertaken by way of negotiated acquisitions. This means that negotiated sale and purchase documents are prepared, negotiated and executed, and those documents contain the terms of the sale and acquisition as well as the rights and liabilities of the parties. In the initial stage, a letter of intent or a memorandum of understanding is drafted containing the terms that the parties aim to enter into during the negotiations. This is replaced later by the sale and purchase agreement. A due diligence investigation is also conducted during the initial stage.

#### Public context

In the public context buyouts are generally concluded by way of a takeover bid that is mainly regulated by the Swedish Act on Public Takeovers on the Stock Market, the takeover rules of the relevant regulated market and statements issued by the Swedish Securities Council. The takeover rules outline the procedures for conducting a public takeover.



Before the offer to acquire the shares in the target company is announced, the bidder must submit an undertaking to the relevant regulated market to be bound by the takeover rules. Once the offer has been announced, the offer document (*erbjudandehandling*) must be submitted to the Financial Supervisory Authority for approval within four weeks. The Financial Supervisory Authority normally approves and registers the offer document within ten working days. The acceptance period may not commence until the offer documentation has been approved and announced. The acceptance period then must be between three and ten weeks. The timetable varies depending on the structure of transaction. The process between the announcement of the offer and the settlement of the consideration can, in relation to cash offers, be expected to take at least approximately six weeks.

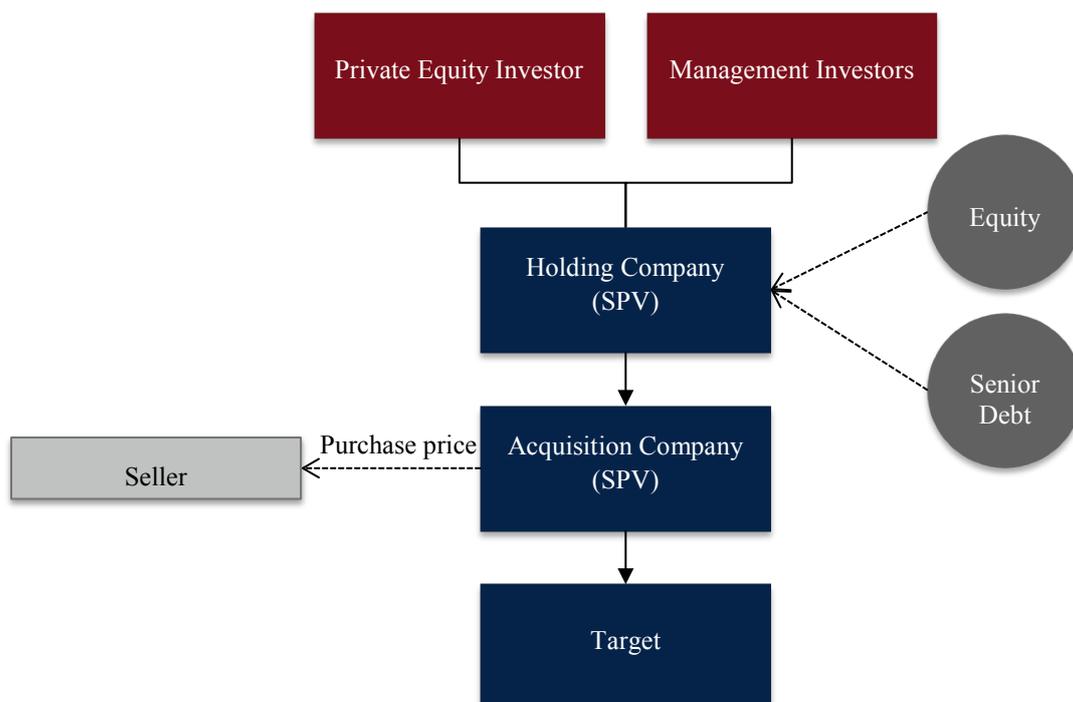
## 6. What is the typical corporate structure used when doing a buyout?

Acquisition structures may vary depending on the type of transaction involved. It is common for management and the investor(s) to jointly form (one or more) special purpose acquisition vehicle(s) (SPV). The SPV is most commonly a Swedish limited liability company.

The management and investors jointly contribute equity capital. This is generally carried out by the issue of new shares (with or without preference rights) or shareholder loans. Furthermore, the Holding Company SPV generally also receives additional financing from banks, funds or similar. The bank debt is usually injected at the Holding Company SPV level but sometimes it may be injected at the Acquisition Company SPV level or at both levels.

The Acquisition Company SPV then purchases the target company from the seller.

More elaborate structures may exist on larger and more complex deals, particularly if any debt funding involves mezzanine funding sources or bonds that may need to be structurally subordinated to the senior financiers but rank ahead of any equity contributed by the private equity fund or funds.



## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

#### *Private context*

For a buyout that is negotiated in a private context, the primary legal document for the transaction is the sale and purchase agreement. There may also be other ancillary transaction documents depending on the nature of the deal. The following documents are key documents during a buyout:

- (a) sale and purchase agreement between the seller and the Acquisition Company SPV in relation to the purchase of all shares in the target company (or the purchase of assets in the target company);
- (b) management investor agreement between either the Holding Company SPV/Acquisition Company SPV and management in relation to the conditions of management's investment in, and employment by, the Holding Company SPV/Acquisition Company SPV;
- (c) shareholders agreement between the investor and management in relation to the ownership and operation of the Holding Company SPV/Acquisition Company SPV; and
- (d) subscription agreement in relation to the management and investors' conditions for investment into the Holding Company SPV/Acquisition Company SPV.

#### *Public context*

For a buyout in a public context, the main documentation to be prepared when the transaction is undertaken as a takeover is:

- (a) an undertaking by the bidder to comply with Nasdaq Stockholm's Rules in relation to Takeover Bids on the Stock Market;
- (b) an offer document (*erbjudandehandling*);
- (c) a statement by the board of the target company in which it announces its opinion in relation to the offer;
- (d) certain press releases which are produced at different stages during the process, the most significant press release is the one announcing the takeover;
- (e) irrevocable undertakings from the existing key shareholders of the target company (if applicable);
- (f) a confidentiality agreement between the bidder and the target if, due diligence is to be carried out;
- (g) in certain situations (e.g., management buyout) a fairness opinion to be prepared by the target;
- (h) any necessary applications for regulatory consents or exemptions; and
- (i) corporate documentation in relation to shareholder meetings and board resolutions.

### Banking

The following documents are the key banking documents necessary during a buyout:

- (a) senior facilities agreement - facilities agreement between the lender(s) and the SPV (and possibly other affiliates within the SPV group, including target companies) under which the terms of the loan made to the SPV are documented;



- (b) mezzanine facility agreement - loan agreement between the mezzanine lender and the SPV (and possibly other affiliates within the SPV group);
- (c) subordinated loan agreement - loan agreement between the shareholder and the SPV (unless funds are provided in the form of equity);
- (d) security agreements - agreements in relation to security to provide the lenders with security for the obligation to repay the loans. The security package commonly consists of share pledges, intercompany loan pledges, an assignments of rights under sale and purchase agreement, bank account pledges, sometimes business mortgages and, where relevant, real estate mortgages and pledges over intellectual property rights;
- (e) intercreditor agreements - where the senior lender, mezzanine lender (if any) and junior creditors agree priority of payment by contract. Structural subordination is common in Sweden; and
- (f) hedging agreements - interest hedging arrangements entered into by the SPV or another affiliate within the SPV group and a hedge counterparty.

## 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

### Private context

It is very common in relation to a buyout in a private context for the share purchase agreement to contain buyer protection provisions. These provisions give the buyer a remedy, before or after closing, for liabilities or defects that exist in respect of the target business (whether hidden or, in some cases, known, to the buyer). Buyer protection provisions may fall into several categories (i.e., representations, warranties, indemnities or independent guarantees). Therefore, when undertaking a buyout in a private context, the buyer can normally expect protection through a standard set of warranties including indemnification, sometimes in combination with escrow or deferred payment arrangements. Warranty & indemnity insurance products are available in Sweden. They are rare although becoming more common.

### Public context

In a buyout in a public context the bidder may make the offer subject to fulfilment conditions relating to, e.g., non-occurrence of a material adverse change. There is a requirement under the Swedish takeover rules that the bidder has secured financing during the entire offer period, including any extensions of the acceptance period, prior to making the bid. If there are conditions to the lender's disbursement of the loan, which the bidder does not control the satisfaction of, these conditions must be included as conditions for the bid if the bidder is able to rely on these conditions for the withdrawal of the bid. It is therefore common to include certain funds provisions in the facilities agreement to limit the conditions to the bid.

Other than that, the bidder's only means of identifying any potential problems would normally be by carrying out due diligence and investigating the target's official records. Control of the target company passes to the bidder on the closing date. If a bidder acquires a controlling stake in the target before or during the offer period, it can, however, gain day-to-day control of a target well before the closing date.

## 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

There are no laws regulating how conflicts of interest are managed in a management buyout. However, the Swedish Companies Act (*Aktiebolagslagen*) (**Companies Act**) does dictate that directors and the managing director must not place themselves in a position of conflict.

Common practice for buyouts is that members of the management team who participate in the buyout are quarantined from any board discussion and decision-making concerning the buyout. It is also common for management, and sometimes the private equity fund, to execute a management protocol setting out certain agreed protocols for information flow and other key interactions during the buyout so as not to disadvantage the seller.

## 10. How are the equity arrangements typically regulated in a buyout?

The equity arrangements in a typical buyout are regulated primarily by a shareholders agreement between the fund/investors, management and any existing management of the target company who are continuing to be employed. Additionally, the SPV's articles of association would include specific share rights attaching to the relevant classes of security to be issued. In Sweden, different classes of security may be differentiated between ordinary and preferential shares.

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur between different stakeholders?

It is common in Sweden to see different classes of security issued to management and the private equity fund in a buyout. A differentiation is made between A-shares and B-shares in Sweden. A-shares provide the shareholder with more influence in respect of the company (note, however, that a B-share is not permitted to correspond to less voting power than 1/10 of an A-share).

It is also common to offer other instruments to the management and the private equity fund, (e.g., convertible preferred stock, which is a preferred stock that includes an option for the holder to convert the preferred shares into a fixed number of common shares, usually any time after a predetermined date). It is also possible to have mandatory convertible shares (i.e., where the company may demand conversion). Traditional stock option programs for employees are also used. Finally, synthetic arrangements are becoming more popular (i.e., synthetic shares and options with no voting rights).

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

Swedish limited liability companies are managed by a board of directors. The board of a private limited liability company must consist of at least one director. If the board consists of one or two directors, at least one deputy director must be appointed. The managing director and at least half the number of directors and deputies, if any, must, without special permission from the Companies Registration Office, be resident in the EEA (which is comprised of the EU member states together with Norway, Iceland and Liechtenstein). Under the Act on Board Representation for the Privately Employed, the employees of a business employing at least 25 persons may appoint two members and two deputy members to the board of directors. A prerequisite for board representation, however, is that there is a collective agreement in force between a trade union and the employer.

Public limited liability companies must have a board of directors consisting of at least three persons. The same residency requirements and employee representation rights apply to public as to private companies. At least half of the directors of the board must be appointed by the general meeting of shareholders. Public limited liability companies must have a managing director.



The Companies Act does not contain any specific rules regarding differential director voting rights. Removal of directors is determined by majority vote at the general meeting of shareholders unless otherwise agreed in the shareholders agreement.

### 13. What measures are commonly used to give a private equity fund some level of control over key operating and financial decisions made by a portfolio company?

Control over operating and financial decisions is generally provided for in the shareholders agreement and is commonplace. It is normally agreed that the private equity fund's rights under the shareholders agreement include:

- (a) the right to appoint one or more directors to the board of the portfolio company (the appointees would consist of fund representatives and external directors with relevant industry experience);
- (b) a requirement that any potentially material decision affecting the portfolio company is made at board level;
- (c) certain rights to receive financial and operating information on a regular basis;
- (d) specific consent or veto rights over particular decisions of the portfolio company, including decisions that relate to operating or financial matters; and
- (e) additional control may be enshrined in the rules of procedure for the board of directors and instructions for the CEO (e.g., by limiting rights and/or setting thresholds for certain decisions).

### 14. What employment terms are generally imposed on management in a buyout?

It is common for senior members of a management team in a buyout to enter into an executive service agreement. This agreement generally includes provisions dealing with the period of notice that must be given before the employment can be terminated. This period is a matter of negotiation and commonly varies depending on the seniority of the relevant manager.

In relation to remuneration, it is also common under an executive service agreement to include a fixed component and a bonus component referable to performance.

Equity incentives offered to management will almost invariably be covered in the shareholders agreement rather than in the executive services agreement.

Finally, the executive services agreement contains loyalty provisions as well as non-compete provisions.

### 15. What equity incentives can be offered to management and how are they typically structured?

Incentives offered to management may be based on financial instruments (e.g., shares and share options) as well as bonus systems (based on the company's financial development or individual goals).

It is not uncommon to implement option programs for management pursuant to which management is offered warrants at a favorable subscription price. The warrants grant management the right to subscribe for newly issued shares in the company on predetermined conditions. The condition for exercise of the warrant (e.g., subscription price and terms) is set out in the warrant instrument.

The option to purchase shares is a common option incentive used in Swedish companies. The arrangement is that at a later stage management is entitled to purchase shares in the company at a predetermined purchase price. To calculate the real value of the option on redemption, the company usually compares the redemption price to appropriate market prices at the relevant time.

## 16. How are buyouts typically debt financed and secured?

While it varies from transaction to transaction, typically approximately 25 to 30% of the purchase price in a buyout is comprised of equity capital.

Senior debt is usually a first mortgage loan in different parts with different conditions (e.g., a- b- and c- tranches). Approximately 50% of the cost of the acquisition is provided by senior debt, and holds the highest priority in the event of bankruptcy.

A 'second lien' is used to secure a smaller portion of the purchase price in a buyout (e.g., 10%). A second lien resembles an ordinary loan, but its repayment has lower priority in the event of bankruptcy, which means that its interest rate is higher. A mezzanine loan is an intermediate loan that is subordinated and is often attached to shares in the purchased company.

A mezzanine loan would consist of approximately 10 to 15% of the purchase price in a typical buyout. A mezzanine loan is given by mezzanine companies and trustees.

The PIK-note (which can be a vendor note with payment-in-kind) is placed at the bottom of the debt structure. This is a high-risk loan that is not repaid or subject to current interest during the term of the loan. Instead, everything is paid back in a bullet payment when the term of the loan comes to an end. The interest on the PIK-note is usually high.

## 17. Are there financial assistance issues to consider when undertaking a buyout?

### The General Loan Prohibition

#### *Definition*

According to the Companies Act a Swedish limited liability company (*aktiebolag*) (**AB**) may not provide monetary loans to:

- (a) a person holding shares in the company or in a company in the same company group;
- (b) a board member or deputy board member, or managing director or deputy managing director of the company or of a company in the same company group;
- (c) a spouse, cohabitant, parent, sibling or other close relative of a person referred to in (a) and (b) above; or
- (d) a legal entity over which a person referred to in (a) to (c) above (alone or together with other persons referred to in (a) to (c)) exercises a controlling influence.

#### *Purpose*

This prohibition against providing loans to persons closely related to an AB (**Restricted Circle**) is usually referred to as the 'General Loan Prohibition'. The purpose of the General Loan Prohibition is twofold, namely to:

- (a) protect the creditors of an AB; and
- (b) prevent tax evasion.



## Security

The General Loan Prohibition applies not only to the provision of monetary loans, but also to the provision of security for monetary loans i.e., an AB may not provide security for a loan made to a member of the Restricted Circle by a third party.

While the general rule prohibits the Swedish AB from providing loans to a Swedish parent company as this is prohibited under ‘a person holding shares in the company or in a company in the same company group’, there are specific exemptions for loans within a company group described below.

### *Company group*

For the purposes of the General Loan Prohibition, a company group is defined as a group of companies the parent company of which is a Swedish AB. This means that if a Swedish limited parent company is, for example, a company domiciled in the United States, the Swedish AB may not provide the parent company with a loan. This would be a loan to a shareholder in violation of (a) above. However, the Swedish AB would be free to loan money to a board member of its U.S. parent company or to a shareholder of that company (as the U.S. parent would not be regarded as a company ‘in the same company group’). If the Swedish AB’s parent company had instead also been a Swedish AB, any loan provided to a shareholder or board member of that company would be prohibited.

It is only the domicile of the parent company that is relevant for the determination whether a company group is a Swedish group according to the definition in the Companies Act. Therefore, the General Loan Prohibition applies in full to loans provided to shareholders in, and a board member or managing director of, a Swedish AB’s subsidiary, irrespective of where the subsidiary has its domicile.

### *Exemptions to the General Loan Prohibition*

There are certain exemptions to the General Loan Prohibition. The most important exemptions are that the General Loan Prohibition does not apply if:

- (a) the loan is provided to a company in the same company group as the AB providing the loan (**Group Exemption**); or
- (b) the AB provides the loan for purely commercial reasons and the loan is intended to be used exclusively in the borrower’s business (**Commercial Loan Exemption**).

In relation to the Group Exemption, a company group for the purposes of the financial assistance provisions of the Companies Act is a group of companies in which the parent company is a company domiciled within the European Economic Area (EEA). Therefore, this definition of company group is wider than the definition of company group used for the purposes of the General Loan Prohibition of the Companies Act and the intention is to exempt loans within a group of companies and to not discriminate against company groups where the parent company is located within the EEA but outside Sweden.

In relation to the Commercial Loan Exemption, the loan must directly or indirectly be of benefit to the business of the lending AB for this exemption to apply. This can be the case, for example, if the loan is intended to finance a business in which the lending AB will take part or in which the lending AB otherwise has an interest. The second requirement, that the loan be used exclusively in the borrower’s business, is intended primarily to prevent loans for private use. Therefore, ‘the borrower’s business’ is not intended to be construed restrictively. A cash pool arrangement, in which companies domiciled outside of the EEA participate, is a typical example of a credit arrangement that usually falls within the scope of the Commercial Loan Exemption. It should also be noted that the business of the borrower must be ‘ongoing’. Therefore the Commercial Loan Exemption is not available if the loan is provided in order for the borrower to start a new line of business.

In relation to a loan made to a shareholder of the lending AB, there is a third exemption to the General Loan Prohibition. The General Loan Prohibition does not apply if the borrowing shareholder, alone or together with closely related persons, holds shares representing less than one percent of the AB's total share capital. Further, a holder of shares in an investment fund as defined in the Investment Funds Act (*lagen om investeringsfonder*) is not regarded as a shareholder for the purposes of the General Loan Prohibition.

Therefore, although the scope of the General Loan Prohibition may seem extensive, because of the ample exemptions to it is not as restrictive as it may seem at first.

## The Acquisition Financing Prohibition

The Companies Act provides that a Swedish AB may not advance funds or provide loans, or provide security for loans, for the purpose of financing the borrower's (or a closely related person's) acquisition of shares in the lending AB or a company higher up the structure in the same company group (defined as a group of companies in which the parent company is a Swedish AB). This prohibition against financial assistance is usually referred to as the 'Acquisition Financing Prohibition'.

The Acquisition Financing Prohibition means that a Swedish AB may not in any way provide means to be used for the acquisition of shares in the lending AB or any company higher up the structure in the same group as the lending AB. However, the Acquisition Financing Prohibition does not prevent an AB from financing an acquisition of the AB's business or a subsidiary of the AB.

The exemptions to the General Loan Prohibition mentioned in the section titled 'Exemptions to the General Loan Prohibition' above, do not apply to the Acquisition Financing Prohibition.

## Exemptions

The Swedish Tax Authority may under certain circumstances grant exemptions from the General Loan Prohibition and the Acquisition Financing Prohibition. Exemption from the General Loan Prohibition may only be granted if there are exceptional reasons (*synnerliga omständigheter*) to do so. Exemption from the Acquisition Financing Prohibition, however, may be obtained if there are special reasons (*särskilda skäl*). Public companies, however, are not able to obtain an exemption from the Acquisition Financing Prohibition.

If the borrowing AB is a company licensed by the Swedish Financial Supervisory Authority (*Finansinspektionen*), the Swedish Financial Supervisory Authority and not the Tax Agency will consider the AB's application for exemption.

## Legal consequences of a violation

If an AB provides a loan or other means of financial assistance in violation of the General Loan Prohibition or the Acquisition Financing Prohibition, that loan is invalid. This means that the borrower is obliged to repay any funds received from the lending AB, regardless of whether the borrower acted in good faith or not.

If, on the other hand, a Swedish company provides security in violation of the General Loan Prohibition or the Acquisition Financing Prohibition, that provision of security is invalid only if the beneficiary of the security realized or should have realized that the provision of security was illegal.

Further, a board member or a managing director, or, under certain circumstances, a shareholder, who intentionally or by gross negligence has participated in a resolution to provide an illegal loan may be liable to pay damages to the lending AB.



The intentional or grossly negligent participation in a breach of the General Loan Prohibition or the Acquisition Loan Prohibition is a criminal offence and may be punished by a fine or imprisonment of up to a maximum of one year.

In addition, under a recent Court of Appeals case, the lending company may be issued with a company fine for the prohibited loan.

## 18. What are the implications under the corporate benefit laws of Sweden for a company providing financial assistance?

Transactions by which a company's capital is decreased are governed by Chapter 17 of the Companies Act and are generally referred to as value transfer transactions and described in the Act as 'any business event as a consequence of which the company's assets are reduced and which is not of a purely commercial nature for the company'.

Permitted value transfers are:

- (a) the distribution of profits;
- (b) acquisition of the company's own shares; and
- (c) reduction of the share capital or statutory reserve for repayment to the shareholders.

There are specific procedural steps to be taken in order to perform any of the above transactions.

Also, any transaction that will cause a decrease in the company's equity and that is not being performed at arm's length is considered to be a value transfer (e.g., if a loan taken by a third party is interest free or extending a credit or otherwise if the applicable interest rate is lower than the market rate). The creditworthiness of the borrower also needs to be considered. To the extent that it cannot be expected that the borrower will be able to repay the loan, it would constitute a value transfer.

If there is no corporate benefit for the company, the financial assistance provided would be treated as a distribution of assets and would be unlawful unless the company has distributable reserves available and sufficient coverage of the company's restricted equity (i.e., equity that may not be paid as a dividend including the registered share capital, the reserve fund, revaluation reserve and the share of equity reserve).

A company's board of directors has a duty to the shareholders of the company to protect the company's capital and the board can, in certain circumstances, be made liable where the capital of the company decreases, in particular where the transaction has not been conducted at arm's length. If funds are transferred unlawfully from the company the receiving party may be liable to repay the sums. Shareholders and board members as well as managers may be ordered to repay any deficiency to the company.

Chapter 25 of the Companies Act states that the board has a duty to draw up an additional balance sheet (*kontrollbalansräkning*) and in some cases even liquidate the company if the company's equity falls below 50% of its registered share capital. If the board members do not take necessary action, they may become personally liable for debts incurred by the company.

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

Typically in a company bankruptcy situation, secured creditors rank ahead of the unsecured creditors and the unsecured creditors, in turn, rank ahead of the shareholders (who are considered to have an unprivileged claim and are therefore at the bottom of the hierarchy of claims). Taxes rank ahead of unsecured creditors (but after the secured creditors), and the government guarantees employee salaries.

A liquidation of a company can either be voluntary or compulsory where all the assets are converted into money and the debts are paid off. Similarly in this situation, the secured creditors rank ahead of the unsecured creditors and the unsecured creditors rank ahead of the shareholders.

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

### Overall tax-treatment of structure

Swedish limited liability companies are subject to national income taxation on their worldwide income. For tax purposes, all corporate income is treated as business income.

Foreign companies are normally subject to national income taxation in Sweden in respect of income derived from Swedish sources (e.g., income from real property situated in Sweden or income derived through a permanent establishment in Sweden). The current corporate income tax rate is 22%.

### Stamp duty/transfer taxes

Generally, stamp duty/transfer tax liability is only triggered on the transfer of real estate in Sweden. Other than that no stamp duty is levied on share transactions or on sale of assets. The tax is based on the higher of the tax assessment value and the purchase price, and is levied at the rate of 4.25% if the buyer is a legal entity.

### Deductibility of interest and financing costs

Sweden has no thin capitalization rules. Instead, interest paid to an affiliate is as a general rule not tax deductible. However, provided that the major reason for the debt being the basis of the interest is not to achieve a tax benefit, the interest is deductible if a corresponding income is taxed at a tax rate of at least 10%. If the affiliate receiving the interest is subject to yield tax (i.e., tax on deemed yield of investments), and if the interest does not exceed 250% of the average interest on government loans it is tax-deductible on the same basis as for other recipients. If the recipient of the interest is resident in the EEA or a state with which Sweden has entered into a tax treaty, the interest may be deductible although the 10% threshold is not met if it is clear that the loan is mainly business motivated. To prove that the loan is mainly business motivated (and not for creating a tax benefit) is difficult and seldom accepted by the courts (court rulings also show that very limited tax benefits makes an intercompany interest non-deductible).

### Withholding tax

Swedish limited liability companies are subject to income taxation on interest income and recipients of interest payable from Sweden are not subject to withholding tax as long as the interest is not deemed to constitute dividends. In that case, withholding tax of a maximum of 30% on dividends could be applicable for foreign residents. However most tax treaties where Sweden is a party include a provision for reduced rates. Moreover, dividends to companies covered by the parent/subsidiary directive are exempt from withholding tax. Exemption also applies to many corporate shareholders holding shares in unlisted companies if the shareholder is subject to income tax of at least 13%.

### Capital gains tax consequences of exit

The general rule is that Swedish limited liability companies must pay corporate income tax on capital gains on the profit from selling shares or receiving dividends. Capital gain is calculated as the difference between the purchase price after deduction of financing and the acquisition costs of the shares in the portfolio company.



### *Swedish resident investors*

Note that capital gain from a sale of shares in private companies, held for business purposes, is tax exempt in Sweden when the capital gain is realized by a limited liability company that is not an investment company. Correspondingly losses from this type of a sale are not tax deductible. If the sold share is assignable to a shell company, the total purchase price is taxed as a capital gain subject to taxation.

Capital gain from the sale of listed shares, held for business purposes, is tax exempt provided that the holding has been deemed to be for business purposes during at least one year prior to the sale when the capital gain is realized by a limited liability company that is not an investment company. Correspondingly losses from this type of a sale are not tax deductible.

### *Non-resident investors*

Non-resident investors that earn capital gains due to the sale of shares are normally not subject to capital gains taxation in Sweden unless the shares are attributed to a permanent establishment in Sweden. However, they may be subject to taxation in their home jurisdiction. For individuals who were tax resident in Sweden during a ten year period prior to the sale, tax liability may remain due to exit tax rules.

## **21. What forms of exit are available?**

In a solvent situation, the most common forms of exit are an IPO, a trade sale (which would help expand the buyer's existing business) or a secondary sale for example to other private equity funds. Dual track exit processes are common in Sweden.

## Switzerland

### 1. What structures do private equity funds typically use to manage their funds?

#### Typical structure

The majority of private equity funds investing in Switzerland are foreign funds structured as offshore limited partnerships established in for example BVI or Guernsey. These offshore funds are also typically managed by an offshore fund manager that enters into an advisory agreement with a local (i.e., Swiss) investment advisor. The Swiss investment adviser does not itself hold any participation in the target companies and typically acts only as the advisor to the actual offshore manager.

#### Alternative structures

There are also a few private equity funds set up as a Swiss limited partnership structure known as a *Kommanditgesellschaften für kollektive Kapitalanlagen (KGK)*. The investors hold limited partnership interests in the limited partnership. A general partner, a Swiss corporation (**AG**) is responsible for the day-to-day management and the operations of the limited partnership.

Private equity investments could also be structured in other ways, for example, through an AG that has either listed its shares at a Swiss stock exchange or has only qualified investors.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in Switzerland?

#### Typical structure

If the private equity fund investing in Switzerland is set up as a foreign fund structured as an offshore partnership, a Swiss investment advisor performing only advisory functions to the foreign fund/fund manager does not need to be licensed. If, however, the foreign fund manager delegates the performance of portfolio and/or risk management functions to the Swiss investment advisor or, if the investment advisor actually acts as an asset manager, the Swiss investment advisor must be licensed as an asset manager of collective investment schemes by the Swiss Financial Market Supervisory Authority (**FINMA**), unless:

- (a) the investors of the collective investment scheme are qualified investors within the meaning of the Federal Act on Collective Investment Schemes (**CISA**); and
- (b) the assets under management do not exceed either:
  - (i) CHF 100 million (if leveraged); or
  - (ii) CHF 500 million (if non-leveraged and a closed-fund).

Depending on the actual activity of the Swiss investment advisor (such as investment management and risk management) and the regulatory regime applicable to the foreign fund, the advisor may also be required to register with FINMA or a self-regulatory organization for compliance with anti-money laundering regulations.

Foreign (offshore) funds that fall within the definition of ‘foreign funds’ under CISA, (i.e., funds actually having their registered office and main administrative office outside Switzerland) do not require a license or authorization from FINMA, if they are exclusively distributed to ‘qualified investors’ as defined in CISA. If, however, the fund’s activities do include distribution to non-qualified investors, a FINMA authorization is required.



Note that all funds (i.e., irrespective of whether they require a license or authorization as described above) must comply with certain formal requirements, in particular the appointment of an official Swiss representative and a Swiss paying agent unless distribution occurs to licensed financial intermediaries.

### Alternative structures

Swiss funds that are set up in the form of a KGK require a license or authorization from FINMA.

Alternative ‘private’ investment structures, such as investment clubs, are, if certain requirements are met, outside the scope of existing laws regulating investment vehicles and do not require licensing.

## 3. Are there any approvals required for investments by foreigners in Switzerland and, if so, what is the process?

There are no Swiss exchange controls and there is no restriction on the repatriation by investors of profits and capital gains from Switzerland. Further, there are no foreign investment approval requirements of general application in Switzerland. However, both foreign investors and Swiss companies controlled by foreign investors need a special authorization in the circumstances set out below.

### Acquisition of real estate or real estate companies

The Swiss Act on the Acquisition of Real Estate by Non-Residents (*Lex Friedrich* or *Lex Koller*) regulates and restricts the acquisition by foreigners of real estate, and must always be taken into consideration if the target company owns real estate. It is no longer necessary, however, to apply for an approval under this legislation if the real estate owned by the target company is used as a permanent place of operation of a business (trade, manufacturing or independent professions). Under certain circumstances (e.g., significant land reserves within the target company; ownership of land used for residential purposes; or acquisition of a real estate company), the approval of cantonal authorities may nevertheless be required for transfers of ownership.

### Acquisition of banks or securities dealers

A foreign investor (individual or entity) wishing to acquire a controlling stake in a Swiss bank or a regulated Swiss securities dealer needs the prior approval of the Swiss Financial Market Supervisory Authority (**FINMA**). Authorization will be granted if:

- (a) the country of the foreign investor grants reciprocity;
- (b) the competent authorities of that country ensure consolidated supervision deemed appropriate by FINMA; and
- (c) the applicant can show that its acquisition of the controlling stake will not affect the regular conduct of the bank’s or securities dealer’s operations.

Furthermore, political discussions to restrict investments by foreigners in relation to strategically important industries continue in Switzerland and across Europe.

## 4. Who are the relevant regulators in Switzerland and how much interaction would one generally expect when undertaking a buyout?

The primary regulators are:

- (a) the Swiss Financial Market Supervisory Authority (**FINMA**);
- (b) the Swiss Stock Exchange (**SIX**) - the major stock exchange in Switzerland that provides additional regulations for listed entities;

- (c) the Swiss Takeover Board - issues general rules and ensures compliance with the applicable provisions regarding public takeover offers; and
- (d) the Competition Commission (**WEKO**) - the competition/antitrust regulators.

The level of involvement with these authorities in a buyout situation largely depends on the nature of the transaction. For example, in a public takeover there is significant interaction with the Swiss Takeover Board and, potentially, FINMA. If the transaction involves a regulated industry sector, there may be involvement with other authorities.

However, in most buyout situations the transaction related interaction with public authorities is typically limited to obtaining written tax rulings from the Cantonal and/or Federal Tax Administrations and merger clearance from WEKO. The level of involvement of WEKO depends on the size of the undertakings involved, whether they meet relevant merger control thresholds under the relevant competition law and the potential impact of the transaction on competition.

## 5. How are buyouts typically undertaken in the private and the public markets?

### Private markets

In relation to privately held companies a buyout is usually undertaken by way of a negotiated acquisition. Sale and purchase documents are prepared, negotiated and executed and those documents record the terms of the sale and acquisition and the rights and obligations of the parties. In some cases, the buyout takes place following an auction process where several potential acquirers are approached and invited by the seller to bid for the target company. The seller ordinarily concludes a sale and purchase agreement with the bidder that offers the highest price and/or the most favorable contractual terms.

### Public markets

The buyout of a target listed on SIX requires a public takeover bid (unless the target company's articles of incorporation provide for an opting-out). A shareholder who holds shares representing more than 33 1/3% of the voting rights of a target must submit a tender offer. The articles of association may provide for a higher threshold of up to 49% (opting up) or declare that the mandatory offer obligations are inapplicable (opting out). Non-public share purchases (i.e., purchases on or off the market not combined with a public offer) are not subject to the tender offer rules unless the threshold for submitting a mandatory offer is exceeded.

An offer document outlining the terms of the offer to the shareholders must be prepared and published by the bidder. Further, the board of directors of the target company must publish a report which contains all necessary information for the shareholders to assess the offer, including, e.g., the intentions of the target's shareholders who hold more than 3% of the voting rights. The report of the board may contain a recommendation.

The bidder in a public takeover bid may squeeze-out the remaining minority shareholders of the target company if the bidder acquires the threshold of 98% of the voting rights of the target company. If the threshold is not met, the Swiss Merger Act alternatively provides for a bidder who has at least 90% of the voting rights of the target company to initiate a squeeze-out merger. In this merger procedure, the bidder forces the remaining shareholders out of the target company against payment of cash consideration at fair market value.

## 6. What is the typical corporate structure used when doing a buyout?

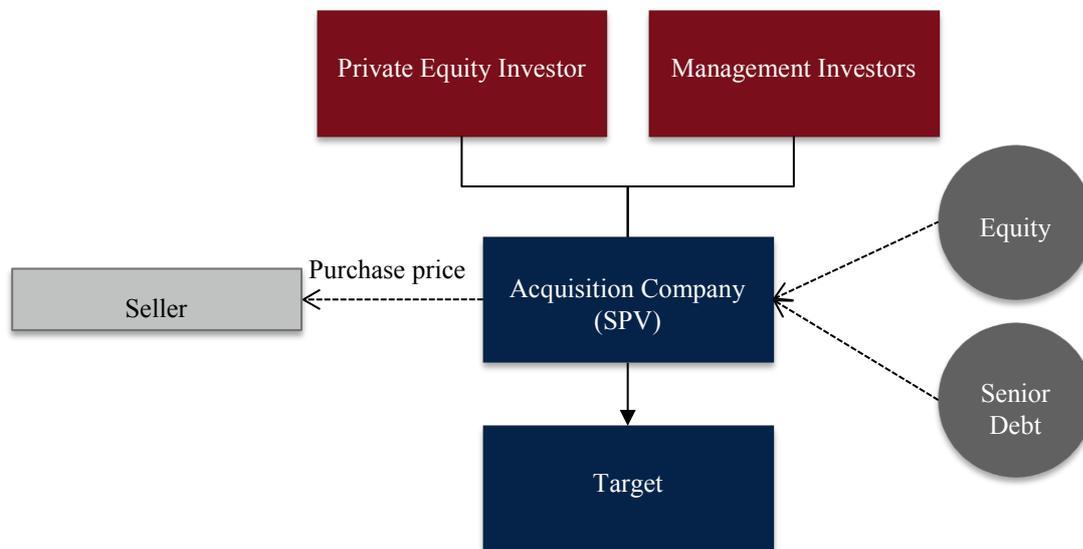
The choice of the corporate structure when undertaking a buyout is typically tax-driven. Nevertheless, the majority of buyouts in Switzerland are structured so that the fund acquires the target company



through a newly incorporated special purpose Swiss company that serves as the Acquisition Company/SPV for the acquisition.

Typically, shortly before signing the deal, the Acquisition Company/SPV is formed as a stock corporation (AG) with the minimum share capital of CHF 100,000. Shortly before the closing of the transaction, the board of the SPV then draws down the committed debt/equity funds to fund the SPV with the required capital to satisfy the purchase price and related expenses.

This simple SPV buyout structure looks as follows:



For structural reasons it may be beneficial to merge the target company and the Acquisition Company/SPV after the acquisition (e.g., to allocate the interest payable for the debt financing to the operating business entity (i.e., debt push down)). In these cases, the sponsor usually sets up a two-level holding company structure to ensure that after the merger the target company is still held through a holding company rather than through the private equity fund itself. However, many Swiss cantonal tax administrations consider the debt push down by merger of the Acquisition Company/SPV with the target company as a form of tax avoidance so that the interest on the acquisition financing may, for a period of generally five years, not be used to offset operating profits unless an alternative (usually complex) tax optimization structure is found.

Generally more elaborate structures invariably exist on larger deals as the funding and tax requirements demand greater complexity.

Structural subordination is not common.

## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

#### *Private market buyout*

Negotiations for a private market buyout are usually based on a term sheet/memorandum of understanding and are carried out either by auction or under an exclusivity agreement. The primary legal documents that record the transaction in a private market deal are:

- (a) the sale and purchase agreement between Newco/SPV and the seller; and

- (b) the shareholders agreement between the private equity investors and the management governing the operations of Newco/SPV.

There are usually also other ancillary transaction documents prepared depending on the nature of the deal, for example an investment agreement, a transition/shared services agreement or employment agreements between the managers and the SPV and/or the target company.

#### *Public market buyout*

For a buyout in a public context the key documentation to be prepared by the bidder includes:

- (a) a pre-announcement of the tender offer (public advertisement);
- (b) an offer document outlining the offer to the shareholders (prospectus); and
- (c) a report of the board of directors of the target company.

### Banking

#### *Lending documents*

The main banking document is the senior facilities agreement under which the senior debt facilities (typically amortizing and non-amortizing term loans with working capital lines and, in some instances, capital expenditure or acquisition facilities) are documented.

If there is mezzanine debt, there is a separate facility agreement under which that debt is made available together with, if applicable, an option agreement (warrant). Subordination is typically implemented through an intercreditor agreement. The relative positions of different debt providers depend on subordination or other contractual agreements between the relevant parties.

Fees are usually recorded in a separate letter rather than in the main facilities agreement.

#### *Security documents*

Separate security documents are required to provide the lender(s) with security for the obligation to repay the loan and the payment of interest. These securities are usually held by a security agent for the lenders. The nature of the security depends on the circumstances of the deal and usually comprises security over the assets of the group such as mortgages, a global receivables assignment, account pledges and/or share pledges.

If the target company (being a Swiss company) or its subsidiaries are required to guarantee the debt funding and/or to grant security over their assets in favor of the lender to secure the repayment obligation of the acquirer, financial assistance issues may arise, which need to be addressed in the target's articles of association (in the purpose clause) and by including appropriate limitation language in the contractual documentation. This is outlined in more detail in the answer to question 17.

### **8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?**

A fund usually undertakes a detailed due diligence exercise in relation to the target company to identify risks and liabilities and, to the extent possible, factor those into the purchase price.

#### Private context

Further, in a private transaction the buyer is usually protected by:

- (a) conditions precedent which need to be met prior to closing the transaction; and



- (b) contractual representations and warranties as well as indemnities given by the seller in the sale and purchase agreement.

The scope of the representations and warranties is usually rather broad and covers the material issues identified in relation to the target company and its business. Indemnities tend to be more specific and typically relate to taxes and environmental issues as well as any other specific issues that have been identified in the due diligence (e.g., litigation issues). The terms of the representations and warranties and the indemnities vary. However, it is quite normal to expect that limits apply including claim thresholds and caps, time limits and adjustments for items otherwise disclosed or accounted for. Exact terms depend on the attractiveness of the target company (i.e., the number of competing bidders) and the price being paid.

To cope with the risk of the seller not being able to pay the buyer's warranty or indemnity claims, the buyer would usually request that a portion of the purchase price be put in escrow for a certain period of time. Alternatively, warranty & indemnity insurance coverage is becoming more and more accepted in the Swiss M&A market.

The buyer may also seek protection in the form of a purchase price adjustment based on a review of the closing accounts. That price structure supports a cash-free/debt-free purchase price and allows for adjustment of the purchase price based on the development of the working capital.

## Public context

In a public context the shareholders tendering their shares into the offer do not give any representations and warranties. If shares are also acquired from majority shareholders, the majority shareholder typically gives a limited set of warranties. All transactions between management and the bidder must be disclosed in the offer document.

## 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

There are no specific laws regulating how conflicts of interest should be managed in a typical management buyout. However, the Swiss Code of Obligations imposes certain general statutory obligations on directors of a Swiss company, including fiduciary duties and the general principle of equal treatment of all shareholders.

If a director/manager of the Swiss company is also an employee, statutory provisions of employment law, including, in particular, duties of loyalty and confidentiality, and non-compete covenants apply. Further, contractual obligations under the employment agreement and/or a service agreement may provide further governance on the handling of conflicts of interest.

In a public takeover, conflicts of interest must be disclosed in the offer documentation.

## 10. How are the equity arrangements typically regulated in a buyout?

The equity arrangements in a typical buyout are primarily regulated by a shareholders agreement entered into by the investing parties at the Acquisition Company/SPV level. Key terms regarding the relationship between the shareholders and the constitution of the company are also reflected in the relevant company's articles of association. The articles of association must be publicly filed.

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

There is a great deal of flexibility under Swiss law regarding the types of equity securities that can be issued and the level of rights tailoring that can occur. This can either be done by creating different rights associated with different categories of shares issued in a buyout (e.g., shares issued to

management and shares issued to the private equity fund). Alternatively, this can be achieved by allocating special rights (e.g., dividend liquidation preference and/or veto rights) to certain shareholders in the shareholders agreement.

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

### Board constituency

Swiss law allows shareholders significant freedom to structure the board and the voting rights of a company. The statutory position is typically modified by provisions set out in a shareholders agreement and/or the articles of association that describe the rights of equity holders to appoint and remove directors, the quorum requirements for any board meeting and the specific veto rights in relation to certain (important) board matters.

There are no requirements in relation to the nationality or residency of the individuals who are appointed to the board. However, at least one fully-authorized representative of the company (whether a board member or a manager) must reside in Switzerland. Further, if different categories of shares were created, the shareholders of each category are entitled to nominate and appoint at least one board member.

### Voting rights

Each director has a single vote in relation to board matters and all decisions capable of being passed by the board may, if there is no provision to the contrary in the articles of association or the shareholders agreement, be passed by a simple majority of directors. The chairman may be entitled to a casting vote.

### Appointment and removal of directors

Under the Swiss Code of Obligations that govern the appointment and removal of directors of a Swiss corporation, directors are appointed and removed by the general meeting of shareholders with a simple majority provided there is no provision to the contrary in the articles of association.

### Listed companies

For listed companies, additional - stricter - corporate governance rules apply, including in particular the ordinance against excessive remuneration by listed companies (which, *inter alia*, provides for restrictions on the remuneration schemes and the term of board members and top management).

## 13. What measures are commonly used to give a private equity fund some level of control over key operating and financial decisions made by a portfolio company?

The fund usually appoints directors to the top company in the group (Holding company SPV or the Acquisition Company SPV, as the case may be) and will reserve, and, depending on the circumstances, exercise the right to have representation on the board of each of the portfolio companies. Representation on the board may include presence on audit, compensation and other committees.

Management of the portfolio company's day-to-day business is usually delegated by the fund, by its representation on the board of directors, to the management team. To do so, the board of directors has to implement organizational regulations governing the delegation of, and control over, the day-to-day management. The organizational regulations are the internal management regulations of the company. These regulations are issued by the board of directors (as opposed to the articles of association, which are a matter of the meeting of shareholders) and govern the organization and competencies of the



board of directors and the management. The organizational regulations do not need to be publicly filed.

Further, the shareholders agreement typically contains a number of veto rights, listing those transactions and matters where the managers need to seek prior consent from the board of directors (i.e., the fund which will have the majority of board seats), before proceeding to carry out any action.

The fund, in the shareholders agreement and organizational regulations, typically requires detailed financial and operating information in relation to the target company to be provided to it by the managers to enable it to closely monitor the performance of its investment.

The banking documents would also contain negative covenants and information requirements.

#### **14. What employment terms are generally imposed on management in a buyout?**

The terms of employment of the managers are set out in an employment agreement and the rights and obligations attached to any shares held by the managers are usually set out in the shareholders agreement.

Typically, a fund would wish to offer incentives to key employees to align the interests of the management team and the fund and, at the same time, would wish to protect the business if a key employee departs or underperforms.

Apart from salary, bonus and other benefits, top-level management may be offered the opportunity to subscribe directly for shares in the Acquisition Company/SPV on preferential conditions. Further, a share option plan may be implemented, which allows managers to participate in the future performance of the company through subscribing for shares in a future investment round, based on their own/the target company's performance. A share option plan typically contains arrangements so that any departing employee does not retain any options already awarded to him or her.

The employment agreement with the managers contains a series of key terms for the protection of the business of the target company, including in particular non-compete and confidentiality provisions to prevent a manager from competing with the target business and soliciting its customers and key employees for a period of time after the departure.

Additionally, if a key employee holds equity in the company, he or she is usually required to sell or transfer those shares on departure.

Strict restrictions in relation to the terms of remuneration of directors/managers apply for listed companies, based on the ordinance against excessive remuneration by listed companies.

#### **15. What equity incentives can be offered to management and how are they typically structured?**

Swiss law provides for a great deal of flexibility in relation to incentives offered to management. These incentives generally take the form of ordinary equity or options over ordinary equity. It is also possible to create forms of phantom equity, but careful planning of phantom equity plans is required.

Management is usually expected to pay for its equity. Sometimes the price paid by the management is lower than the price paid by the private equity investors (sweet equity) or a favorable loan is granted to the managers to purchase the shares. In some cases, management is offered a 'ratchet' on their equity that operates to give them a greater overall return if the investment for the private equity fund outperforms certain base return thresholds (usually measured by reference to the fund's internal rate of return on the investment or an absolute money multiple).

Typically, the future relationship between the private equity shareholders and the management shareholders is governed by the shareholders agreement. The fund and the management may also enter into a share option/participation agreement that sets out the terms of participation in the new company. The shareholders agreement may provide for a vesting period. The vesting of the shares may also be subject to the achievement of agreed milestones. The shareholders agreement typically also includes a right of the Acquisition Company/SPV to re-acquire a manager's shares if that manager ceases to be employed by the company. Good leaver and bad leaver provisions are very common in the shareholders agreement and provide for different prices to be paid for the shares in these two scenarios.

A shareholders agreement typically deals with the following issues:

- (a) drag along/tag along rights;
- (b) trade sale/IPO-obligations (e.g., lock-up);
- (c) call/put options other than under the leaver scheme; and
- (d) anti-dilution protection for the management.

## 16. How are buyouts typically debt financed and secured?

The financing structure of a buyout typically consists of senior debt in the form of term loans and revolving credit facilities provided by banks and other financial institutions. In addition to the equity investment, the private equity fund may also provide financing in the form of mezzanine debt or subordinated shareholder loans.

Mezzanine debt which is subordinated to the senior debt but ranks ahead of any shareholder loans may also be provided by a range of other participants (e.g., specialist mezzanine finance providers, the seller (if it wishes to maintain an interest) or a senior debt provider (in addition to the senior debt)).

Typically, the banks providing the acquisition financing ask for the existing debt of the target company to be refinanced and for the existing security to be released and re-used as collateral for securing the repayment obligation of the acquisition financing. As mentioned in the answer to question 7, there are limitations in relation to securities provided by the target company.

In a public company buyout the offer documents (i.e., the prospectus) provide information in relation to the financing of the offer, including a confirmation from the auditors that the bidder has taken all measures to ensure that the required financing will be available at closing.

## 17. Are there financial assistance issues to consider when undertaking a buyout?

Although Swiss corporate law does not have any explicit rules on financial assistance, there are several provisions protecting the nominal capital as well as the reserves of a corporation. Therefore, a corporation incorporated in Switzerland may not make payments to its parent company unless that payment is made:

- (a) as a formal dividend;
- (b) in the course of a formal reduction of the company's nominal capital; or
- (c) on the basis of an arm's length contract.

Based on the current legal doctrine, payments to a sister company are subject to these same provisions as payments to a parent company. Payments to a subsidiary are, as a rule, not subject to restrictions.



However, exceptions are possible under certain circumstances, for instance, if the subsidiary is not a wholly-owned subsidiary of the relevant corporation.

Furthermore, the granting of a security interest or a guarantee to a third party (e.g., a lender in relation to an acquisition credit facility agreement) for obligations of a parent or a sister company (**Upstream or Cross-stream Security**), as well as other acts having a similar effect (such as an indemnity or the waiving of rights for the benefit of a parent or a sister company), are subject to the same principles as an actual payment. In practice, this means that ‘financial assistance’, or rather the provision by the target company of a security for financial indebtedness of the direct or indirect parent company (shareholder of the target company) or a sister company, is limited to the amount that the target company could freely distribute to its shareholders as a dividend at the time payment is demanded.

Swiss law does not provide for a ‘whitewash’ procedures or similar measures to avoid or mitigate the consequences of an Upstream or Cross-stream Security. For an Upstream or Cross-stream Security to be valid (for the limited amount outlined above), the following steps need to be taken in accordance with standard market practice:

- (a) (re-)drafting of the articles of association of the Swiss entity to explicitly permit upstream and cross-stream undertakings;
- (b) formal approval of the transaction document providing for an Upstream or Cross-stream Security not only by the board of directors but also by the shareholders of the relevant corporation; and
- (c) insertion of limitation language into the relevant transaction document that provides for the limitation of the security interest or guarantee.

## 18. What are the implications under the corporate benefit laws of Switzerland for a company providing financial assistance?

If the provision of financial assistance is not made within the scope of a permissible payment to a parent company (see the answer to question 17), the relevant contractual undertaking may not be binding on the company due to a deemed lack of capacity of the individuals entering into the relevant agreement on its behalf. In that case, any payment made under a guarantee or a suretyship or the proceeds from the realization of a security interest may be reclaimable.

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

Swiss insolvency laws are fairly complex in relation to the priority of claims between different creditors, and, in particular, different secured creditors. However, as a general rule, a secured creditor is in a better position than an unsecured creditor, and ordinarily has priority. There are exceptions to this rule, for example, where the security was created in circumstances where it may be challenged.

Secured and unsecured creditors rank ahead of any return on the equity to the shareholders. Further, under Swiss insolvency laws there are different classes of creditors (such as employees and the tax office) with different priority in the case of liquidation proceedings.

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

There are a number of Swiss tax issues to be considered at every stage of a buyout, particularly in relation to:

- (a) tax treatment of the issue or the increase of equity capital and transfer of shares (e.g., Swiss stamp taxes);

- (b) tax treatment of the subscription of equity by an employee, share option plans and executive compensation (e.g., Swiss income taxes);
- (c) tax treatment of the interest charges arising on any acquisition finance, including the deductibility of those interest charges against profits of the operating company (e.g., Swiss corporate income and capital taxes and Swiss withholding tax);
- (d) tax treatment of the distribution of dividends (e.g., Swiss withholding tax); and
- (e) tax efficient structuring of an exit solution.

Privileged tax regimes (e.g., for holding structures) are available, but are under increased scrutiny by the EU and the OECD. Tax holidays may be granted to industrial companies in particular.

Typically, privileged tax regimes and the tax consequences of significant transactions involving Swiss companies are secured by written tax rulings issued by the cantonal and federal tax authorities.

## 21. What forms of exit are available?

The common forms for an exit are:

- (a) an IPO – for an IPO on SIX, the target company is required to be a certain minimum size and usually both the private equity fund and management, is required to retain at least a portion of their shares and to agree to a lock-up for a period agreed with the underwriter (usually between six and 18 months);
- (b) a trade sale to a corporate or other strategic investors which typically provides a complete exit for the fund;
- (c) a sale to another private equity firm (a secondary buyout) – where the fund exits and management normally rolls over (i.e., reinvests) at least a portion of its proceeds into the new company; and
- (d) a leveraged recapitalization – whereby the existing acquisition finance facilities are replaced by a new financing and cash is returned to the shareholders through the payment of dividends, a share buyback or a reduction of capital.



## Taiwan

### 1. What structures do private equity funds typically use to manage their funds?

There are currently no locally-established private equity funds in Taiwan. However, most of the offshore private equity funds making investments in Taiwan use a typical limited partnership structure to manage their funds.

The limited partnership (the ‘fund’) is managed day-to-day by the general partner (which is a corporation). The fund obtains capital commitments from certain qualified investors such as pension funds and financial institutions. These investors become passive limited partners in the fund partnership and when the general partner identifies an appropriate investment opportunity, it is entitled to call for the required equity capital and at that time each limited partner funds a *pro rata* portion of its commitment.

Although the Limited Partnership Act was drafted in 2004, it has not yet come into force. Accordingly, there is currently no legislation governing limited partnerships in Taiwan.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in the Taiwan?

There are currently no laws or regulations specifically governing private equity funds in Taiwan. If established in Taiwan, the relevant private equity fund entity would be likely to be a limited liability company and would require registration with the Ministry of Economic Affairs (**MOEA**).

There are currently private equity funds incorporated in other jurisdictions that carry on business in Taiwan. For foreign private equity funds investing in Taiwan, there are no specific licensing requirements unless the fund seeks to establish and register a branch in Taiwan.

However the fund may need to be registered as a ‘Foreign Institutional Investor’ (**FINI**) in relation to its purchases of securities on public markets (the Taiwan Stock Exchange (**TSE**) and the GreTai Securities Market (**GTSM**, the over-the-counter market)) and may require foreign investment approval in relation to the investments it makes in Taiwan (refer to the answer to question 3).

If the fund proposes to market and sell securities (including units in its fund) in Taiwan, whether by way of public offering or private placement, then the fund and its securities offered must be registered with the Securities and Futures Bureau of the Financial Supervisory Commission and the securities will be subject to applicable laws and regulations.

### 3. Are there any approvals required for investments by foreigners in Taiwan and, if so, what is the process?

#### Foreign investment

##### *Foreign Investment Approval (FIA)*

Foreign investments are regulated by the Statute for Investment by Foreign Nationals (**SIFN**) and the regulator in Taiwan is the Investment Commission of the MOEA (**Investment Commission**).

Under the SIFN, foreign investors must apply for, and obtain Foreign Investment Approval (**FIA**) from the Investment Commission in order to:

- (a) establish a subsidiary or joint venture company;
- (b) acquire shares from existing companies (other than those shares listed on the TSE or GTSM);  
or

- (c) increase the amount of equity investment in an enterprise.

The major incentives FIA companies enjoy include:

- (a) rights of repatriation of equity and loan investments, profits, interest and capital gains;
- (b) waivers of resident and nationality requirements of various statutes;
- (c) no expropriations for a period of 20 years, as long as the foreign investor continues to hold at least 45% of the total capital of the FIA company;
- (d) exemption from the requirement to issue 10%-15% of the new shares to employees or the public, if at least 45% of the stock of an FIA company is foreign-owned;
- (e) a dividend withholding rate of 20%; and
- (f) exemption from income tax for expatriates who conduct pre-FIA activities and meet certain residency requirements.

The Investment Commission maintains a blacklist that includes one industry sector in which foreign investment may be restricted by percentage (i.e., telecoms) and another in which foreign investment may be wholly prohibited (i.e., military products). To obtain a FIA, a foreign investor must submit a completed application form together with the required documents (i.e., an investment plan, a business operation plan, a shareholder list and information about the investor) to the Investment Commission for examination.

While the usual period required for an FIA application to be approved is four weeks, if the total amount of the investment (i.e., buyout) exceeds USD 50 million, the application needs to be presented to the monthly meeting of the Investment Commission, which representatives of relevant government departments attend, for review and it could take up to two months or more for the Investment Commission to approve the application.

#### *Opening up Chinese investments in Taiwan*

Until recently, PRC citizens and entities organized under the laws of the PRC were prohibited from investing, directly or indirectly, in Taiwan. However, since 2009, the Taiwan government has adopted several regulations making PRC investments in Taiwan possible, so that inbound investments by PRC investors are now allowed with the approval of the Investment Commission.

PRC investors are allowed to invest in 100 businesses of which 64 are in manufacturing, 25 are in the services sector and 11 are in the infrastructure sector. For infrastructure businesses, there are further restrictions on the shareholding percentage and total investment amount in relation to airport terminals and seaports.

#### *Requirement to register as a FINI*

As mentioned in the answer to question 2, foreign institutional investors are required to register as a FINI in relation to their purchases of securities on public markets (the TSE and the GTSM) and may require FIA status in relation to each other investment they make in Taiwan. A foreign investor buying more than 10% shares of a listed company requires FIA in addition to FINI status. The FINI and FIA status can be obtained concurrently.

In April 2009 the FSC passed the PRC Securities Investment Regulations that allow direct investment in Taiwan securities listed on the TSE and GTSM. In 2010, the FSC passed draft amendments to relax certain provisions of the law relating to financial services sector (banks, securities and futures exchanges, insurance companies), in particular, allowing cross-establishment of branch offices by institutions in both Taiwan and mainland China, and clarifying the requirements for PRC entities (or entities with PRC shareholdings) to invest in those sectors.



## Foreign exchange controls

Taiwan exercises foreign exchange controls over inward and outward remittances. The control applies only to the conversion of foreign exchange into local currency or vice versa, but not to the ownership of foreign currency.

Foreign exchange settlement can be made through a foreign exchange bank by submitting to the Central Bank of the Republic of China (Taiwan) (**CBC**) a Foreign Exchange Payment or Receipt Transaction Declaration Form accompanied by evidentiary documents. However, no such prior approval is required for the following payments or receipts:

- (a) revenue from exports of goods or services;
- (b) payments for the import of goods or services;
- (c) revenue from, or expenditure relating to direct investment approved by MOEA; and
- (d) where the aggregate remittance payments during a calendar year is:
  - (i) less than USD 50 million for a resident entity or branch office; or
  - (ii) less than USD 5 million for resident individuals, or remittance by a non-resident individuals or entities of sums less than USD 100,000. (Note that these ceilings are subject to periodical adjustment by the CBC).

All other payments require the prior approval of the CBC, which is generally difficult to obtain.

## 4. Who are the relevant regulators in Taiwan and how much interaction would one generally expect when undertaking a buyout?

The most important regulators involved in a buyout transaction are:

- (a) the Investment Commission of the Ministry of Economic Affairs (MOEA) (**Investment Commission**);
- (b) the Securities and Futures Bureau (**SFB**); and
- (c) the Taiwan Stock Exchange (**TSE**) and the Gre-Tai Securities Market (**GTSM**), the over-the-counter market.

The Investment Commission's FIA approval is required for foreign investment into Taiwan (refer to question 3 above). The SFB is the governmental securities regulator for public companies.

Certain industries are subject to specific regulation and may be subject to the jurisdiction of other governmental/regulatory agencies. This needs to be confirmed in each case. Therefore, depending on the nature of the transaction and the industry in which the buyout takes place, reporting to, or the approval of, other regulatory authorities may also be required. For example, if the acquisition is in the banking industry, then the Financial Supervisory Commission would have jurisdiction and may need to approve the transaction. Furthermore, if the buyout transaction triggers competition or antitrust issues, then the Fair Trade Commission's prior approval would also need to be required.

## 5. How are buyouts typically undertaken in the private and public markets?

### Private companies

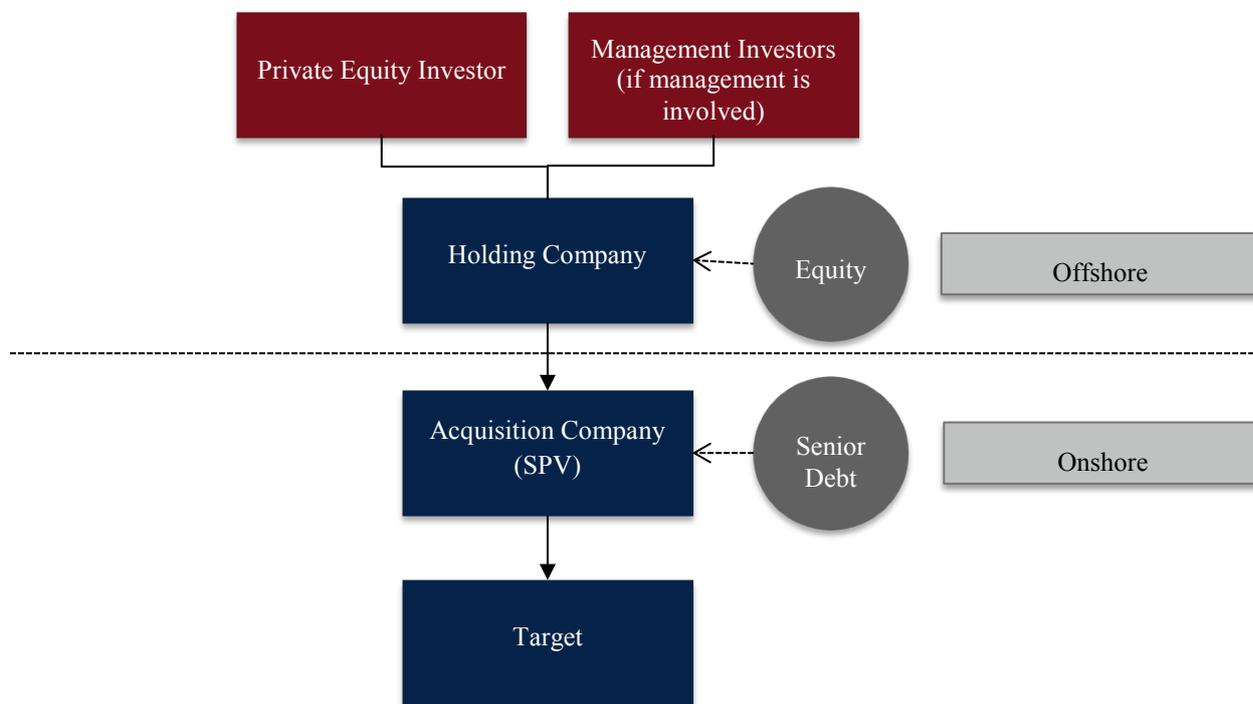
Private companies are acquired through privately negotiated share purchase transactions (i.e., negotiated sale and purchase documents are prepared, negotiated and executed and those documents record the terms of the sale and acquisition and the rights and liabilities of the parties).

### Publicly-listed companies

While both public and private transactions are permitted, most of the buyout transactions in Taiwan are of publicly-listed companies and occur in the public market by way of public tender offer in accordance with the ROC Business Enterprise Merger Law and the Regulations Governing Tender Offers for Purchase of the Securities of a Public Company. The offeror is required to make a filing in relation to the tender offer to the Financial Supervisory Commission and may set the tender offer with a minimum and maximum number of shares that it wishes to purchase and a tender offer period between 10 to 50 calendar days. All the terms and conditions of the tender offer are required to be set out in the tender offer prospectus.

## 6. What is the typical corporate structure used when doing a buyout?

The most common structure is:



The fund typically establishes an offshore holding company through which it makes its investments worldwide. This offshore holding company and its ownership will have been determined largely on the basis of multi-jurisdictional tax considerations. The offshore holding company establishes a special purpose subsidiary company in Taiwan to serve as the acquisition vehicle (**Acquisition Company/SPV**) (As discussed in the answer to question 3, FIA approval is required to establish the Acquisition Company). As the Acquisition Company is a Taiwanese corporate entity, the fund (through the acquisition vehicle) does not need to comply with regulatory requirements applicable to foreign investors. The Acquisition Company/SPV may seek to borrow funds locally at Taiwan's comparatively low interest rates to leverage its acquisition.



## Acquisition Company/SPV

The Company Law recognizes four types of locally incorporated companies. Two of these (companies limited by shares (CLS) and limited companies (LC)), provide all shareholders with limited liability. The other two are both unlimited liability companies and so are rarely used. Among the four business vehicles, a CLS is the most commonly used by foreign investors.

### CLS

A CLS may either be composed of two or more shareholders or one shareholder that is a government or a legal entity. A CLS must also have authorized capital, at least one quarter of which must be paid in full before its incorporation can be completed. In addition to the requirement of authorized capital, a CLS must also have minimum paid up capital, the amount of which varies depending on the type of company in question.

A company engaged in a business without an industry-specific minimum capital requirement must have a capital of at least TWD 500,000. Minimum paid-in capital may be used for any business purpose immediately after it is paid in. After the initial issue of shares and on subsequent issues of new shares, a CLS must offer 10% to 15% of its newly issued shares to its employees, unless the company has FIA approval and is 45% or more owned by foreign investors.

### LC

An LC can have one or more shareholders, half of whom must be Taiwan nationals holding more than 50% of the registered capital. However, this requirement is waived for foreign investors who have acquired FIA approval for an investment in an LC. An LC must have a minimum capital of TWD 250,000 unless provided otherwise, with the amount of capital contribution by each shareholder provided in the company's articles of incorporation.

## Publicly listed target company

Typically, if the target company is a public company (most common in buyouts in Taiwan), the Acquisition Company must launch a tender offer to the shareholders of the target company. Once the tender offer has been accepted by the required number of shareholders and is considered successful, the Acquisition Company conducts a share swap or merger and uses cash or preferred shares as consideration to acquire shares held by those shareholders who did not accept the tender offer. These preferred shares are subject to certain terms and conditions that facilitate the squeezing out of the minority shareholders of the target company. Following the completion of the share swap or merger and squeezing out of the minority shareholders, the fund may decide to take the target company private.

## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

In the case of buyouts, the documentation to be prepared generally includes the following:

- (a) memorandum of understanding between the parties;
- (b) shareholders agreement;
- (c) management agreement between management and the Holding Company SPV;
- (d) tender offer prospectus (in the case of public company buyouts);
- (e) equity roll-over commitment agreement under which the majority shareholder accepts the terms of the tender offer in relation to some or all of its shares and uses the proceeds to

participate in the offshore Holding Company SPV (in the case of public company buyouts); and

- (f) share purchase agreement (in the case of private company buyouts) (with seller's representations and warranties, a disclosure letter and indemnities).

## Banking

If the acquisition is leveraged and funded locally, a term loan agreement and a securities pledge agreement are generally required. It is typically a loan secured by the assets of the target company post closing. When there is a tender offer, a commitment letter issued by banks is also usually required.

### 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

In private company transactions, buyer protection usually takes the form of negotiated warranties, representations and indemnity coverage from the seller. The terms of that coverage vary from transaction to transaction.

In the context of an unlisted public company, the level of buyer protection which can be obtained is less than in a private context. The buyer is normally only protected by the provisions under the conditions precedent to the acquisition and any other warranties and representations made by the sellers in relation to the business of the target company. Warranty & indemnity insurance is available in Taiwan but not commonly used.

For listed public company transactions, there is usually no protection available to the buyer other than the assurance of knowing that the company must comply with securities laws and the listing rules of the TSE and the GTSM, that it is regulated by the SFB, and that it must be audited and publish its financial statements.

### 9. Do laws exist regulating how conflicts of interests are managed in a typical management buyout?

The Company Act of the Republic of China (**Company Act**) regulates conflicts of interest in a management buyout.

In particular, the Company Act provides that a shareholder that has a personal interest in a matter under discussion at a meeting that may affect the interests of the company, must not vote nor exercise a voting right on behalf of another shareholder. This principle also applies to managers who are directors voting at the meeting (i.e., where the director's self interest may impair the interests of the company, that person is prohibited from voting at the meeting). This would include a situation where a manager also potentially has a conflict of interest in relation to contractual obligations that he or she may owe to the target company under a service agreement.

Management protocol letters are not used in Taiwan.

### 10. How are the equity arrangements typically regulated in a buyout?

The equity arrangements in a typical private company buyout are regulated primarily by way of a shareholders agreement either at the Holding Company or Acquisition Company level. The relevant company's articles of incorporation would also include specific rights attaching to the relevant classes of shares to be issued.



## 11. What class of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

There are generally two types of equity security issued by a company: common shares and preferred shares. Preferred shares may have different terms from common shares but each class of shares (whether common or preferred) must have the same terms.

## 12. What laws exist in relation to board constituency, different director voting rights and the removal of directors?

### Board constituency

A CLS must have at least three directors who are elected by the shareholders whereas an LC is permitted to have one director only. Directors are not required to be residents of Taiwan. Private companies may also regulate the appointment and removal of directors in a shareholders agreement subject to complying with company law. Under Taiwan company law, the directors are elected by way of cumulative voting and the removal of directors requires a two-thirds majority of the shareholders' vote.

Public companies must have at least five directors serving on the board. Under the regulations and the listing rules of the TSE and the GSTM, listed public companies must have at least two independent directors among the members of the board, and one of the independent directors must be an accounting or a financial professional.

Unlisted public companies may stipulate in their articles of incorporation the number of independent directors they wish to have on the board. However, the SFB takes into consideration the size of the company, the shareholding structure of the company, the nature of the business and other relevant matters and may issue an order at its discretion to require certain unlisted public companies to have at least two independent directors on the board. In any event, the number of the independent directors must not be less than one-fifth of the members of the board.

### Differential voting rights

A board meeting must be held by way of a physical meeting or, if it is clearly stipulated in the articles of incorporation of the company, by way of video-conference. A written resolution is not allowed in Taiwan. In addition, the enforceability of voting arrangement among shareholders in relation to the allocation of board seats is not clear in Taiwan. Voting arrangements regarding veto rights in relation to certain reserved matters as well as share transfer restrictions, lockups, right of first refusal, tag along right, drag along right are generally enforceable in Taiwan.

Each director is entitled to one vote on the board (i.e. there is one vote for each director). Differential voting rights are not allowed. This applies to both public and private companies (including CLS and LC).

Normally a vote is passed by a 50% quorum plus a majority vote, except in relation to major corporate actions (such as a merger or spin-off). These major corporate actions require a 50% quorum and a two-thirds majority vote. The chairman is also a director so he or she may cast a vote. All of these arrangements can be set out in the shareholders agreement.

### Removal of directors

Under the Company Act, the directors may be removed from the board by a resolution of the shareholders' meeting by a two-thirds majority of the shareholders' vote or by judgments rendered by the courts of the Republic of China.

### 13. What measures are commonly used to give private equity fund some level of control over key operating and financial decisions made by a portfolio company?

A level of control over key operating and financial decisions made by a portfolio company is normally obtained by way of relevant provisions in a shareholders agreement. The common provisions included in a shareholders agreement are:

- (a) provisions that give private equity funds the right to appoint one or more directors to the board of the portfolio company (at both the operating company and Holding Company/Acquisition Company levels);
- (b) provisions that entitle private equity funds to receive financial and operating information on a regular basis; and
- (c) specific consent or veto rights over particular decisions of the portfolio company, including decisions that relate to operational or financial matters.

### 14. What employment terms are generally imposed on management in a buyout?

It is common for senior members of a target company's management team to enter into an executive service agreement. It is not uncommon to require the management team to stay for a fixed employment period although the relevant agreement would include a required period of notice that must be given before employment can be terminated. The notice period is a matter of negotiation depending on the seniority of the relevant manager.

The remuneration of the managers quite often includes a fixed component and a bonus component referable to performance. However, equity incentives offered to management are separately covered in the shareholders agreement rather than the executive service agreement.

### 15. What equity incentives can be offered to management and how are they typically structured?

In Taiwan, the equity incentives offered to management are similar to those offered in other countries. The incentives normally include ordinary equity or options over ordinary equity of the offshore Holding Company. Share option plans are commonly used.

It is not uncommon for management to be offered a ratchet in relation to its equity which operates to give management a greater overall return if the investment for the private equity fund outperforms certain base return thresholds. The share options offered under the option plans are usually capped at a fixed percentage of the total shareholding of the Holding Company/Acquisition Company.

### 16. How are buyouts typically debt financed and secured?

In Taiwan, recent transactions have seen 60-70% of the cost of an acquisition financed by senior debt provided by banks. The amount of debt that can be raised is typically calculated as a multiple of the earnings of the target business. For foreign investors, the Investment Commission requires the debt-to-assets ratio to be at least 2:3 (i.e., on completion of the transaction, the total debts of the target company must not exceed 2/3 of the total assets of the target company so, for example, if the total assets of the target company is USD 100 million, the total debts of the target company must not exceed USD 66.7 million).

Security is typically by way of a share pledge over the shares of the special purpose vehicles used in the transaction and the target company.



## 17. Are there financial assistance issues to consider when undertaking a buyout?

Regulatory restrictions on a company providing financial assistance vary, depending on the type of financial assistance. There are two relevant scenarios which we discuss below.

### Providing a loan to the acquirer

Under Article 15 of the Company Law and the Regulations Governing Loaning of Funds and Making of Endorsements/Guarantees by Public Companies (**Lending and Guarantee Regulations**), a company is prohibited from lending to any of its shareholders or any other person, except in the following circumstances:

- (a) where an inter-company or inter-firm business transaction calls for the lending arrangement; or
- (b) where an inter-company or inter-firm short-term financing facility (not more than one year) is necessary.

The borrower should be a 'company'. A company is prohibited from lending money to a natural person.

The amount of loans under exception (a) must be equivalent to the amount of the inter-company transaction (such as the supply, sale or distribution) between the lending company and the borrower. The amount of the short-term financing facility under exception (b) must not exceed 40% of the net worth of the lending company. The responsible persons of a lending company (such as the directors, supervisors and managers) who breach these regulatory restrictions will be liable, jointly and severally, with the borrower, for repayment of the loan and any damage suffered by the lending company as a result of any breaches.

There is no further provision or government interpretation that clarifies the above two exceptions.

However, it is unlikely that the provision of a loan by a company to the acquirer, which does not have other business transactions with the lending company, would be deemed to fall within exception (a). The short-term financing between the acquirer and the lending company is limited to a term of not more than one year and subject to the 40% net worth restriction.

### Providing a guarantee or collateral to secure the obligations of the acquirer

Under Article 16 of the Company Law, a company shall not act as a guarantor of any nature, unless otherwise permitted by any other law or by its articles of incorporation.

Under Article 5 of the Lending and Guarantee Regulations, a public company may make endorsements/guarantees or provide collateral to secure the obligation of the following companies:

- (a) a company with which it does business;
- (b) a company in which the public company directly and indirectly holds more than 50% of the voting shares; and
- (c) a company that directly and indirectly holds more than 50% of the voting shares in the public company.

Companies in which the public company holds, directly or indirectly, 90% of the voting shares may make endorsements/guarantees for each other, if the amount of the endorsements/guarantees does not exceed 10% of the net value of the public company. Companies in which the public company holds 100% of the voting shares are allowed to make endorsements or guarantees for each other without being subject to this 10% restriction.

Where a public company fulfils its contractual obligations by providing mutual endorsements or guarantees for another company in the same industry for the purposes of undertaking a construction project, or where shareholders make endorsements or guarantees for their jointly-invested company in proportion to their shareholding percentages, those endorsements or guarantees may be made free of the restrictions set out under Article 5 of the Lending and Guarantee Regulations.

Therefore, generally, a private company may provide a guarantee or collateral to secure the obligations of the acquirer, if the articles of incorporation of that private company allow it to do so. A public company may provide a guarantee or collateral for the obligations of the acquirer which owns 50% of its voting shares.

Some companies state in their articles of incorporation or internal rules relating to guarantees and endorsements a maximum amount of guarantee and endorsement that the company may provide to others. If the accumulated amount of guarantees and endorsements exceeds that maximum amount, a shareholders' meeting must be convened to amend the articles of incorporation and/or the internal rules.

## **18. What are the implications under the corporate benefit laws of Taiwan for a company providing financial assistance?**

In Taiwan, directors and managers of a company have a duty to act in good faith for the benefit of the company as a whole and for a proper purpose. This duty is prescribed under the Civil Code as well as under Article 23 of the Company Law.

As this duty also applies to dealings between companies in a corporate group, when considering providing financial assistance for the acquisition of a company's shares, the directors and managers in charge of providing that financial assistance must continue to act in good faith for the benefit of that company.

As explained in the answer to question 17, if the exceptions to the Lending and Guarantee Regulations do not apply, a company is not permitted to provide a loan to a party that intends to acquire shares in that company or in its parent company. Any director acting in violation of these regulatory restrictions will be liable, jointly and severally, with the borrower, for repayment of the loan and any damage suffered by the lending company because of the loan.

With regard to other types of financial assistance, it is essential that the director and manager in charge of providing the financial assistance comply with their fiduciary duties and obligation to act in good faith. As it may be difficult to determine whether a director or manager acts for the benefit of the company, it is generally recommended that the company pass a board resolution or hold a shareholders' meeting, as the case may be, to approve the provision of any financial assistance.

## **19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?**

The Company Law provides that all creditors must be paid before any distribution can be made to shareholders. Among creditors, secured creditors take priority over unsecured creditors in relation to the company property subject to the security. There are also preferential debts that must be paid in priority to creditors and shareholders under separate legislation including in relation to taxes and certain amounts payable to, or in relation to, employees.



## 20. What are the general tax and duty considerations for a fund when undertaking a buyout?

### Stamp duty

Generally speaking, there is no stamp duty imposed on share sale and purchase transactions documentation. If however a document that is to be entered into constitutes a receipt for monetary payment under the Stamp Duty Law, that document may be subject to stamp duty. If there is any part of the documentation related to the transaction that may be subject to stamp duty, the parties may decide to execute those documents overseas based on the accepted practice that there is no stamp duty payable on documents executed outside Taiwan. If this approach is taken, the documents must be executed outside Taiwan before a notary public and legalized by the Taiwan Government Representative Office having jurisdiction in the relevant region.

### Securities transaction tax

A securities transaction tax (currently 0.3% of sale proceeds) is imposed on the sale of shares but not on asset purchases or certain types of mergers. The tax is required to be deducted by the purchaser as a withholding tax from the purchase price and paid to the Taiwan National Tax Authority, although the tax is ultimately borne by the seller of the shares.

### Thin capitalization

The maximum allowable inter-company debt to equity ratio in Taiwan is 3:1, limiting the company's interest expense deduction on debt to three times its capital. Withholding tax at the rate of 20% is payable on interest paid on a shareholder loan made by an offshore shareholder to a local company and can be reduced by tax treaty, if applicable.

### Capital gain tax

Foreign corporate investors are always exempt from capital gain tax and are also exempt from a special tax regime (the Alternative Minimum Tax) if they do not maintain a fixed place of business or engage a business agent in Taiwan.

### Withholding tax

For foreign investors, withholding tax is an important issue if returns are to be repatriated by way of dividends, interest or royalties. The current withholding tax rate is 20%, however if the recipient of the dividend, interest or royalty is resident in a country with which Taiwan has negotiated a double tax treaty, then the withholding tax rate may be reduced to 10%. Reference must be made to any applicable double tax agreement in each case.

## 21. What forms of exit are available?

For a solvent publicly-listed company, the most common forms of exit are sale on the TSE or GTSM or issue of American Depositary Receipts in relation to the company's listed shares. For a solvent private company, the most common form of exit is by an IPO or by private sale of the shares of the portfolio company.

## Turkey

### 1. What structures do private equity funds typically use to manage their funds?

Most Turkish private equity funds have historically been established outside Turkey. Although there are a number of tax incentives provided to venture capital and portfolio management operations, in practice, most private equity funds still prefer to raise funds abroad and invest in Turkey through a special purpose vehicle (SPV) established in Turkey. To date, very few private equity funds have set up their licensed venture capital corporations in Turkey.

Turkish portfolio management companies can be used to manage portfolios of private equity funds. These companies are regulated under the Portfolio Management Communiqué Serial No. III - 55.3 (**Portfolio Management Communiqué**). Under the Portfolio Management Communiqué, Turkish portfolio management companies can be set up to manage exclusively and solely the portfolios of non-Turkish resident persons and entities. In this respect, the Portfolio Management Communiqué aims to create a market for Turkish portfolio management companies where these companies manage the portfolios of non-Turkish private equity funds. These entities are also subject to licensing by the Capital Markets Board (CMB).

### 2. Do funds need to be licensed by any regulatory authority to conduct business in Turkey?

#### Offshore funds

As described in the answer to question 1, most private equity funds raise funds abroad and invest in Turkey through an SPV and do not maintain their portfolio management operations in Turkey (in which case there is no licensing required from a Turkish law perspective).

Some offshore private equity funds have established liaison offices in Turkey. Under Turkish law, liaison offices cannot undertake any commercial operation, and as such, they are not subject to any licensing in Turkey, other than the license initially required to establish the liaison office. This license is granted by the General Directorate of Foreign Direct Investment under the Ministry of Economy for a period of three years. It is renewable on expiration if the activities of the liaison office are deemed beneficial to the Turkish economy. The liaison office is not required to bring capital into Turkey, however, the expenditures of the liaison office (e.g., salaries and rent), must be paid from abroad in foreign currency.

#### Private equity funds located in Turkey

If a private equity fund is located in Turkey, it needs to be licensed by the CMB either as a venture capital or portfolio management company as described in the answer to question 1. The CMB must approve the fund's bylaws, and an agreement must be signed between the founder and the portfolio escrow, followed by registration with the trade registry. Venture capital investment participation certificates, which are capital market instruments issued in the name of the investors of a fund displaying their rights and contribution, can only be issued to qualified investors. Following the establishment of the venture capital investment fund, the application for the issue of participation certificates must be made within six months, after the registration of the bylaws. On the CMB's approval, the participation certificates may be issued to investors.



### 3. Are there any approvals required for investments by foreigners in Turkey and, if so, what is the process?

#### Foreign investment

Foreign investments in Turkey are primarily governed by the Foreign Direct Investments Law No. 4875 (**FDI Law**) and the Regulation on the Implementation of the Foreign Direct Investments Law (**FDI Regulation**).

As a general principle, the FDI Law treats foreign investors and Turkish investors equally.

The FDI Law defines foreign investors as:

- (a) citizens of foreign countries and Turkish citizens residing abroad; or
- (b) legal entities established abroad under the laws of foreign countries or international institutions.

Although prior approval is not required, share transfers by foreign persons (other than routine capital market transactions) must be reported to the Foreign Investment General Directorate of the Under Secretariat of the Treasury (**General Directorate**) within 30 days of completion of the transaction. An annual report obligation to the General Directorate with respect to their operations is also imposed.

#### *Industry-specific regulation*

In general, if the sector of the target company is regulated, it is likely that the sector regulator's approval will be necessary for the transaction. Examples are the Banking Regulation and Supervision Agency for acquisition of banks and certain other financial institutions; the Capital Markets Board for brokerage houses, portfolio management companies and other companies active in the capital markets; the Treasury for insurance and pension companies; the Energy Market Regulatory Authority for energy distribution and generation companies; and the Radio and Television Supreme Council for acquisition of broadcasting companies. Note that further exceptions exist in terms of limitations to foreign capital in certain strategic sectors such as transportation and broadcasting.

#### *Real estate*

Turkish companies with direct or indirect foreign shareholding of over 50% are restricted from acquiring real estate in strategic locations or locations close to military bases. They must obtain prior clearance from the relevant governorate. In the case of a buyout, a notification will be made within one month following the buyout if the target company holds any real estate.

Even if the relevant real estate is located in a location that is not restricted as described above, Turkish companies with foreign shareholding still need to make a filing to the governorate to determine whether the real estate is in a restricted area. However, this is a straightforward process.

Companies established in a jurisdiction outside Turkey cannot acquire real estate in Turkey regardless of the location of the real estate, with certain exceptions such as real estate relating to petroleum rights, tourism, or industrial zones (all of which are subject to the approval procedures specified under the relevant legislation).

#### Exchange controls

The government abolished restrictions on Turkish Lira convertibility by facilitating the exchange by foreign investors of proceeds from Turkish securities transactions by Council of Ministers Decree No. 32 on protecting the Value of the Turkish Currency (**the Currency Protection Decree**). This enables Turkish citizens to purchase securities on foreign securities exchanges; permits residents and non-residents to buy foreign currency without limitation and to transfer foreign currency abroad; and permits Turkish companies to invest abroad without ministerial approval. International transfers,

however, should be reported to the Under Secretariat of the Treasury (under the Capital Movement Circular issued by the Central Bank).

The Currency Protection Decree also allows persons not residing in Turkey to purchase and sell shares in Turkish public companies, provided transactions are facilitated through a Turkish bank or brokered under Turkish capital markets law, and the relevant gains and the purchase price are transferred through a bank or suitable financial institution licensed in Turkey.

The Currency Protection Decree regulates foreign exchange transactions and instruments representing foreign currency (including securities and other capital market instruments), and the use and management of foreign exchange and imports and exports of Turkish currency. Persons residing abroad may freely transfer funds to Turkey either in Turkish currency or foreign currency. Certain limitations apply, however, regarding exporting Turkish currency and foreign currency.

Funds in Turkish currency or foreign currency may be freely transferred abroad through Turkish banks. Turkish banks are, however, required to notify the Central Bank regarding transfers greater than USD 50,000 (or its equivalent in Turkish or other currency) within 30 days of the transfer. An exception exists for transfers made for import, export and 'invisible' transactions.

#### **4. Who are the relevant regulators in Turkey and how much interaction would one generally expect when undertaking a buyout?**

There are no restrictions or approvals that are specifically applicable to buyouts in Turkey. However, depending on the nature of the buyout and target, three regulators or types of regulators may have jurisdiction over the buyout as set out below.

##### **Competition Authority**

If the size of the target and/or the parties to the buyout exceed a certain threshold, the Competition Authority's approval is necessary. The Competition Authority's involvement would be limited to reviewing the buyout purely from an anti-trust point of view. Unless the buyout is problematic from an antitrust perspective, interaction with the Competition Authority would be very limited and as a result of its review, it would grant an approval/clearance, grant a conditional approval or reject the application.

##### **Capital Markets Board**

The CMB has jurisdiction over buyouts generally if the target is a public company. Although the buyout of a public company does not require the CMB's approval *per se*, the CMB's jurisdiction inevitably extends to these types of transactions in the context of tender offers, post-closing mergers or any concept that requires the protection of the minority investors. The level of the CMB's involvement and interaction would depend on the reason for its involvement.

##### **Specific sector regulators**

If the target company is in a regulated sector, it is highly likely that the relevant regulator's approval would be necessary for the buyout. Examples are:

- (a) the Banking Regulation and Supervision Agency for banks and certain other financial institutions;
- (b) the CMB for brokerage houses, portfolio management companies and other companies that are active in the capital markets;
- (c) the Treasury for insurance and pension companies;



- (d) the Energy Market Regulatory Authority for energy distribution and generation companies; and
- (e) the Radio and Television Supreme Council for broadcasting companies.

Usually, filings with these regulators must be very detailed and cumbersome and the relevant regulator's involvement is not limited to ticking the boxes only but also includes a strategic review in relation to the impact of the proposed buyout in the sector that the relevant regulator regulates.

## 5. How are buyouts typically undertaken in the private and the public markets?

### Private companies

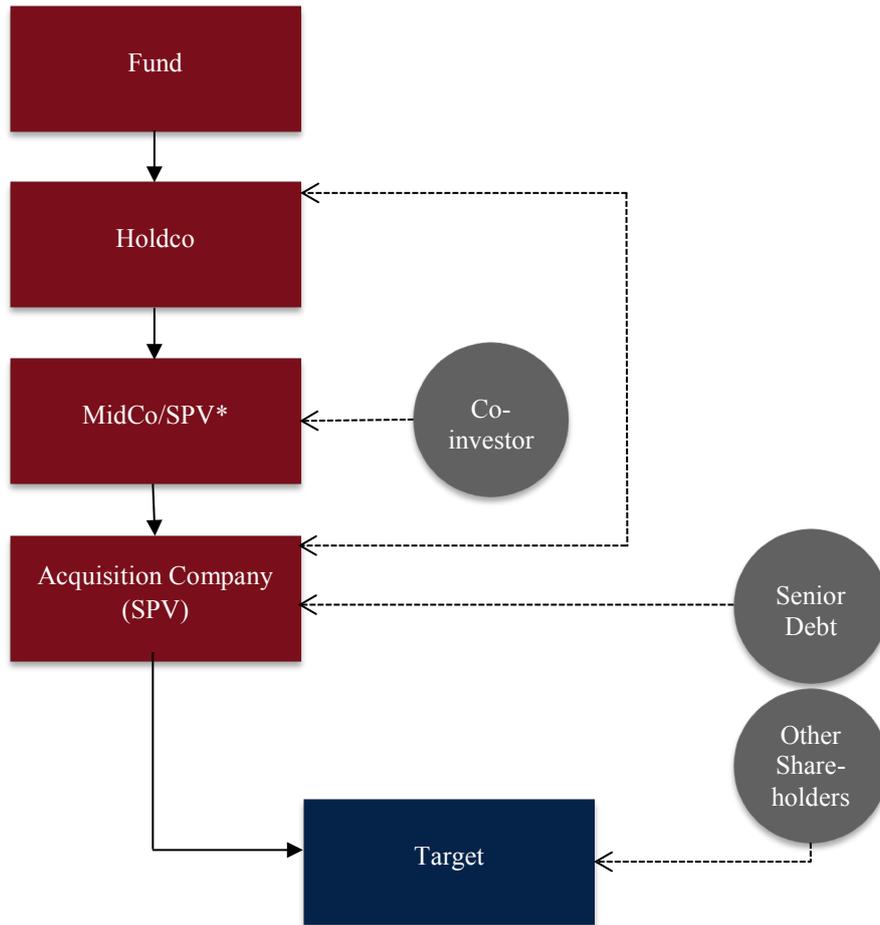
Buyouts of private companies are typically undertaken through the acquisition of the target's shares, subscribing for the target's shares through a capital increase, or both. Usually, the process involves a legal and financial (and in some cases commercial, environmental or technical) due diligence, followed by negotiations between parties and execution of the share purchase agreement and/or a share subscription agreement and shareholders agreement, depending on the specifics of the transaction.

### Public companies

No regulatory approvals are required for buyouts of public companies, and the same steps as for a private company are followed. However, the content and coverage of the agreements are different, most often with a lower coverage of operational warranties and lower indemnity ceilings compared to private company buyouts. Following the execution of the transaction documents, the purchaser starts preparations for the mandatory tender offer, for which an application must be filed with the CMB within 45 business days after closing.

## 6. What is the typical corporate structure used when doing a buyout?

In line with global trends, corporate structures used in buyouts in Turkey are mainly tax-driven and private equity funds seek the most advantageous taxation structures when doing a buyout. As a result, usually private equity funds set up a special purpose acquisition vehicle in tax advantageous jurisdictions such as Luxembourg or the Netherlands in order to undertake the buyout. As in many other countries, the structure would have multiple layers, with a parent company (Holding Company SPV) funded by the fund through equity injection, below which there are one or more layers of SPVs (which may be funded through equity or debt financing or a combination of the two). Co-investors may contribute to the financing at either the Holding Company SPV level or at one of the other SPV levels. The corporate structure can be observed from the following flow chart:



\*There may be more than one MidCo depending on the fund flow.

Post-buyout mergers of the target company and the Acquisition Company (SPV) are common. However, they need to be considered carefully particularly from a tax and financial assistance perspective.

## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Preliminary documents

The preliminary documents typically include a binding non-disclosure agreement between the seller and the purchaser at the beginning of the process, followed by a non-binding term sheet or a non-binding offer. Usually the main difference between a non-binding term sheet and a non-binding offer is the inclusion of a binding exclusivity clause in a non-binding term sheet.

### Share purchase agreement/subscription agreement/asset purchase agreement

Depending on the specifics of the buyout, the main document governing the acquisition can be either a share purchase agreement, a subscription agreement (and in certain cases a combined share purchase and subscription agreement) or an asset purchase agreement. All of these agreements follow international trends in terms of style but also include provisions addressing Turkish law issues and requirements.



## Shareholders agreement

Unless 100% of the target company is acquired, the buyer and existing shareholders of the target company typically execute a shareholders agreement, which governs, among other things, the management and funding of the target company as well as share transfers. Typically, a shareholders agreement is signed at the Acquisition Company SPV level only if there are co-investors at that level. Management buyouts and buy-ins are not common in Turkey, and therefore management would rarely be party to the shareholders agreement.

## Other corporate documents

A buyout also requires a number of additional corporate documents to be prepared. These documents typically include amendments to bylaws of the target company, board of directors and/or shareholders resolutions, share certificates and registrations with the trade registries.

Foreign investors should note that Turkish law is cumbersome in terms of formality requirements and notarizations and apostille (for documents that are issued outside of Turkey) are frequently required. Besides corporate documents that are to be notarized, a transfer of the shares of limited liability companies (*limited şirket*) must be executed before a Turkish notary public, whereas this requirement does not apply to joint stock companies (*anonim şirket*).

## Financing documents

If the buyout includes acquisition financing, the financing documents (mainly the facility agreement and security documents) are also negotiated and executed during the buyout process. The financing documents are mainly LMA standard documents whereas the security packages are in line with Turkish market standards and mainly include share pledges, mortgages, an assignment of receivables and commercial enterprise pledges. Please refer to the answer to question 17 regarding the financial assistance prohibition under Turkish law.

## 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

Funds usually undertake a thorough commercial, legal, financial and tax due diligence before signing binding transaction documents. The issues spotted during that exercise are usually addressed by purchase price adjustments or in the transaction documents.

### Private context

The main source of protection for buyers is the share purchase agreement. This agreement would typically offer the protections to the buyer that are set out below.

#### *Conditions precedent*

The inclusion of conditions precedent in a share purchase agreement is common practice in Turkey. Conditions precedent typically include regulatory approvals and the fixing of any legal or regulatory breaches.

#### *Representations, warranties and indemnities*

A share purchase agreement usually includes a number of representations and warranties, including title to shares and capacity as well as operational warranties. It is common for the seller to provide operational warranties unless the seller itself is a fund. If the seller is a fund, management would not provide warranties, and the seller Acquisition Company/SPV would provide warranties only regarding validity and title to the shares and the seller's capacity to enter into the share purchase agreement.

Warranty & indemnity insurance policies have been available in Turkey for some years although they have not been as popular as they are in other parts of Europe. However, we expect them to become more popular as awareness of them grows.

Specific indemnity provisions are usually used for protection against issues that have been disclosed to the buyer and yet the buyer still wishes to seek coverage from the seller due to the significance of the issue and/or unwillingness of the seller to accept a purchase price adjustment in respect of that issue.

#### *Material adverse change*

Most share purchase agreements include a material adverse change clause for the period between the signing and the closing of the transaction. However, there is a trend towards excluding these clauses due to the macroeconomic environment.

#### *Escrow arrangements*

Depending on the outcome of the due diligence, the buyers may seek protection through cash or share escrow arrangements.

### Public context

Both the Turkish Commercial Code (**Commercial Code**) and the Capital Markets Law offer squeeze-out options for majority shareholders of companies. There are two types of squeeze-out of minority shareholders under the Commercial Code: merger squeeze-out and squeeze out for bad faith. Squeeze-out for bad faith is not applicable for listed companies.

According to the Capital Markets Law and the related communiqué, a shareholder, alone or acting in concert with others acquiring 98% or more of the total votes of a public company, can exercise their squeeze out right to buy out the minority shareholders (this threshold will be 97% from December 31, 2017). Once a majority shareholder becomes eligible to squeeze-out minority shareholders, the minority shareholders will first have the right to sell out its shares to the majority shareholder within three months and at a different valuation method from the majority shareholder's squeeze out pricing.

## 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

Management buyouts and buy-ins are very uncommon in Turkey. Therefore, it is not possible to say that there is an established market practice in relation to management buyouts. Furthermore, there are no specific laws governing management buyouts or addressing conflicts of interest arising from them.

However, under the Commercial Code, directors of a company have a fiduciary duty to act in the best interests of the company and must act prudently and diligently. Therefore, directors are subject to a duty of care in that they must carry out the company's business with the caution and care that may be expected from a prudent business person.

Management buyouts, to the extent they display a breach by the directors of their obligation to act prudently and diligently in the best interests of the company, may result in the board being liable to the company, its shareholders as well as its creditors. If the company has suffered loss as a result of the acts of the directors during the buyout, the creditors and the shareholders may also request that the directors indemnify the company to remedy that loss.

Like many other jurisdictions, Turkey has stringent rules against insider trading. Therefore, managers that are undertaking a management buyout of a public company must be careful that the buyout does not breach the regulations against insider trading.



## 10. How are the equity arrangements typically regulated in a buyout?

Equity arrangements are typically regulated through a subscription agreement and shareholders agreement to which the buyer, and the remaining shareholders of the target company (if any) and sometimes the target company itself, is a party. The fund itself does not usually inject equity or funds into the target company directly, but through SPVs (refer to the answer to question 6).

It is possible to restrict the pre-emption rights of existing shareholders of the target company in a capital increase provided that certain conditions are met. The Commercial Code provides that the pre-emption rights may be restricted, with the affirmative vote of 60% of the capital of the company, if there is a just cause for the restriction and all shareholders are treated equally. Examples of 'just cause' are the necessity of that restriction for the public offering of the company, the takeover of another business by the company or the option rights of employees. This also applies to public target companies. However, investors should be mindful of the close supervision of the CMB and lawsuits that may be filed by the minority investors.

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

The Commercial Code takes a liberal approach in relation to the classes of equity and granting certain privileges to certain classes of shares. Therefore, tailoring rights among shareholders is easy and common. Different classes of shares can be created under the company's bylaws (through a board of directors' proposal and the affirmative decision of the majority of the general assembly of shareholders), and these classes can be granted different privileges. Examples of these privileges are veto rights or increased voting rights (multiple votes per share) at the general assembly of shareholders, the right to appoint board members and dividend arrangements.

There are however limitations applicable to creating privileges:

- (a) The maximum number of votes that can be granted per one share is 15. However, if there is a valid ground or presence of a need to 'institutionalize', it is possible to attach more than 15 votes per share, with a commercial court decision certifying the presence of those conditions. The valid grounds are not listed in the Commercial Code itself and the concept of 'institutionalization' is not specifically and clearly described and there is a lack of court precedent of examples of valid grounds as the Commercial Code is relatively new. However, the rationale of the law provides examples for this concept and states that restructuring of a company in order to recover it from distress or protection of shareholders in public companies can be considered some of the valid grounds for the interpretation of this provision. Similarly, the rationale of the law describes institutionalization as a plan aimed to create a sustainable company (i.e., as opposed to a family business), which is managed with corporate governance rules and procedures. The presence of valid grounds and institutionalization is assessed by courts on a case-by-case basis.
- (b) In companies directly or indirectly controlled by the state and governmental authorities, labor unions, associations or foundations, it is only possible to create privileged shares in favor of these controlling shareholders; other private company or individual shareholders cannot hold privileged shares in this type of company. However, this does not apply to financial institutions.
- (c) Even if a shareholder holds privileged voting rights (such as increased voting rights), these voting rights will not be taken into consideration in relation to decisions of the general assembly of shareholders regarding amendment of the company's bylaws or filing a lawsuit in relation to the liability of the directors. For these matters, each share will be deemed to have one vote only.

- (d) The number of directors appointed by privileged voting rights cannot exceed half of the total number of directors in a public company. This rule of law, however, is not applicable to companies where the privileged voting rights to appoint more than half or all of the board of directors were determined prior to 13 January 2010.

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

The constituency of the board of directors of a Turkish company is mainly governed by the Commercial Code. Different sets of provisions are applicable to limited liability companies (*limited şirket*) and joint stock companies (*anonim şirket*) in relation to the board of directors. As most target companies in buyouts are joint stock companies, this section concentrates on the board of directors of a joint stock company.

### Joint stock companies

The board of directors of a joint stock company may have only one director, without any upper limit on the number of directors. Both individuals and legal entities can serve as directors. However, if a legal entity serves as a director it needs to be represented by an individual.

Unless otherwise provided under the bylaws, the board of directors is appointed by a simple majority of the general assembly of shareholders. However, certain classes of shares may be granted privileges to appoint directors to the board.

The board of directors makes decisions with a simple majority, unless the bylaws require a higher quorum, and each director has one voting right. Differential director voting rights are not permitted under Turkish law, and the chairman of the board of directors has no casting vote. However, reserved matters can be determined under the bylaws, which may require a higher quorum, or may require the affirmative vote of a director to be appointed by a certain class of shares.

The removal and release of directors is subject to a general assembly of shareholders' decision, unless a director resigns or is unable to remain a director (e.g., in death or bankruptcy). The individual representative of a legal entity director can be easily removed by the legal entity itself, without a general assembly of shareholders' decision.

It is not possible to vote by proxy at a meeting of the board of directors.

### Public companies

Publicly traded companies are subject to corporate governance rules, regulated under the CML and the Corporate Governance Communiqué, Series: IV, No: 56 (**Corporate Governance Communiqué**). Implementation of some of these rules by publicly traded companies are mandatory, but the rest of the rules are optional. Furthermore, some companies, depending on their market capitalization, may be subject to some lighter provisions with regards to corporate governance, as provided under the Corporate Governance Communiqué. These rules include:

- (a) the board of directors of public companies must consist of five or more members, of which the majority must be non-executive. One third of the directors (and at least two directors in any case) must be independent. Criteria for independent board members have been set out in detail under the Corporate Governance Communiqué. These criteria are aimed to secure the independency of the board members and therefore the independent board member should not:
- (i) be employed (or his/her spouse or other relatives must not be employed), in a senior position by the company or any of its related parties or an entity related to the shareholders holding 5% or more of the share capital of the company, or must not



- have been engaged in any material commercial transactions with those parties in the previous five years;
- (ii) work in or act as the director of a company carrying out any part of the company's operations or organization, including the companies providing audit, rating or consultancy services to the company in the last five years;
  - (iii) be an employee or director of a company providing material products or services to the company in the last five years;
  - (iv) have, nor may the director's spouse or other relatives have, any direct or indirect shareholding relationship with, or employment or commercial interest in, the company, its subsidiaries, affiliates or any other related parties within the last two years;
  - (v) hold privileged shares of the company or shares representing more than 1% of the share capital of the company;
  - (vi) be working full time in public entities, except for university professors; and
  - (vii) be a director of the company for a total period of six years in the last ten years;
- (b) for public companies with a market capitalization below TL 250 million, it is sufficient to maintain only two independent directors (regardless of the total number of directors), while listed banks must have at least three independent directors;
- (c) on the approval of the CML, public companies with an equal joint control of two shareholders may also maintain only two independent directors. Additionally, the Corporate Governance Communiqué provides for a number of committees to be established under the board of directors of public companies, such as the early risk assessment committee, audit committee and corporate governance committee; and
- (d) as an optional rule, the Corporate Governance Communiqué provides that 25% of the board of directors of public companies must consist of female directors.

### 13. What measures are commonly used to give a private equity fund some level of control over key operating and financial decisions made by a portfolio company?

In practice, private equity funds secure control over the substantial decisions of the portfolio company by appointing a director (or in some cases more than one director) to the company's board. In the context of a buyout, the majority of the directors would be appointed by the private equity fund.

Often, the private equity fund's aim is to not interfere with the day-to-day business of the company. However, the private equity fund usually limits the signature authorities of the professional management so that important transactions cannot be undertaken without a board resolution or the signature of a fund representative. Additionally, it is very common for the shareholders agreement to include a list of reserved matters for the decisions of both the general assembly of shareholders and the board of directors, especially in cases where the private equity fund is a minority shareholder, which will also be reflected in the bylaws of the company.

Furthermore, most funds require management to periodically provide detailed management reports, and require the target company to be audited by an independent audit firm.

## 14. What employment terms are generally imposed on management in a buyout?

Managers in a buyout are granted rights and benefits to encourage higher performance and loyalty to increase the value of the business and therefore result in a better exit. Certain restrictions and obligations are also imposed on managers. Both the incentives and the restrictions are regulated under the managers' employment contracts and agreements governing the managers' incentive package. These agreements are subject to the rule of freedom of contract. However, in most cases managers' employment contracts are subject to the Labor Law, which places a high value on employees' rights, and strictly protects employees' rights and benefits. Therefore, some restrictive provisions, explained below, may not be fully enforceable in practice, since Turkish courts may find their implementation against the employees' benefit.

### Incentives

Incentives range from performance bonuses, cash incentives or stock options, as explained further in the answer to question 15 below.

### Restrictions and obligations

The most common restrictions imposed on management are non-compete and confidentiality obligations. Non-compete clauses cannot be drafted with an unlimited validity period following the termination of the employment contract, and must be limited to a period of time (usually two years). 'Whole time effort' clauses, which provide that managers must devote all of their time to the target company, are also common in practice.

It is crucial to set business and performance objectives with the right to dismiss the manager if these objectives are not met, with a gardening leave provision, which keeps departing managers away from the business during their notice period especially in buyouts conducted by private equity funds. Note however that these provisions may be regarded as against the benefit of the employees by Turkish labor courts, and may be unenforceable. However, the courts' evaluation will depend on a number of variables, including the relevant manager's role and authority, the company type, the organizational structure and the manager's rights. Therefore the potential enforceability of these clauses must be evaluated on a case-by-case basis.

## 15. What equity incentives can be offered to management and how are they typically structured?

In practice, private equity funds offer management certain incentives in order to achieve higher performance and align the fund's interests with the interests of the managers. Incentives may include cash incentives (which are usually structured as synthetic equity incentives), or genuine equity incentives where the managers are entitled to equity in the operational target company or, more frequently, in a SPV at a level above the operational/portfolio company.

There are no restrictions under Turkish law for equity incentives. However, incentives may need to be approved at the target company's annual general assembly of shareholders if the incentivized manager is on the company's board of directors. In practice, equity incentives are granted on exit, either as a specific share option right, or by the shareholders paying the managers the amount equal to the relevant equity portion in cash. This incentive arrangement is typically detailed and agreed on in the employment or service contract between the fund and the manager. Additionally, each shareholder's contribution to the equity, and the terms and period of payment by the shareholders, is typically regulated in the shareholders agreement.



Equity incentive packages typically include good leaver and bad leaver provisions (under which the management is not entitled to any benefits granted by the incentive package if their means of departure from the company constitutes a contractual breach).

## 16. How are buyouts typically debt financed and secured?

In practice, commonly, for debt financing of buyouts, banks prefer senior debt secured by collateral over the target company's assets and subordinated loans. The concept of subordination does not exist under Turkish law in the way it exists in many other jurisdictions. Subordination is only contractually binding and is not enforceable against third parties in the case of liquidation or bankruptcy. Mezzanine financing structures are possible under Turkish law for financing, but they are not common, again, due to problems of specific enforcement.

## 17. Are there financial assistance issues to consider when undertaking a buyout?

### Financial assistance by joint stock companies

Under Turkish law, financial assistance is considered to be a circumvention of the prohibition on a company acquiring its own shares, and is regulated under the Commercial Code. Under Article 380 of the Commercial Code, a joint stock company (*anonim şirket*) in Turkey must not provide an advance, loan or security to third parties to support the acquisition of its own shares or that transaction will be null and void. This also applies to a Turkish target company that is a joint stock company.

Financial assistance through provision of advances, loans or securities is prohibited regardless of timing. In other words, the target company cannot provide financial assistance as described above, even after the target's shares are acquired.

### Financial assistance by companies that are not joint stock companies

The prohibition against the giving of financial assistance does not apply to other types of companies in Turkey such as limited liability companies, collective companies and commandite companies. Therefore any company in Turkey that is not a joint stock company can provide financial assistance subject to complying with general legal considerations such as capital maintenance.

### Parent companies

Financial assistance provided by a Turkish company in connection with the acquisition of its parent company's shares is not specifically regulated under the Commercial Code. It could be concluded therefore that there is no limitation in relation to a Turkish company providing financial assistance for the acquisition of its parent company's shares.

On the other hand, circumvention of law (i.e., achieving a result that is forbidden by law by using other legal mechanisms), is not permissible under Turkish law. There is no specific reference under the Commercial Code to providing securities, advances, loans and other sorts of financial support to a Turkish company in connection with the acquisition of its parent company's shares. One could argue, however, that a Turkish joint stock company providing financial assistance for this purpose is a circumvention of law and is prohibited. The use of this type of mechanism has not yet been tested in the Turkish courts and it is not possible to foresee whether Turkish courts will interpret this as a circumvention of the law.

The Commercial Code requires the parent to compensate its subsidiary, if the parent forces the subsidiary to provide financial assistance and the subsidiary suffers a loss.

## Exceptions

There are two exceptions to the prohibition on financial assistance. Firstly, credit and financial institutions (mainly banks) may provide assistance for the acquisition of their own shares. Secondly, a company may provide advances, loans or securities to support the acquisition of its shares by its employees or its subsidiaries' employees as part of their stock options.

## Further requirements

Under Turkish corporate governance rules, if the Turkish subsidiary is a joint stock company whose shares are publicly traded, it may not grant a security or guarantee in favor of third parties in any circumstances unless that grant of security or guarantee is in the ordinary course of the Turkish subsidiary's business or the relevant third party is consolidated into the financial statements of the public company. If it does grant a security or a guarantee, the Turkish subsidiary's board must also resolve to approve the transaction, with affirmative votes by the majority of its independent directors.

### 18. What are the implications under the corporate benefit laws of Turkey for a company providing financial assistance?

In Turkey, directors owe a fiduciary duty to the company while acting on behalf of the company, which they must carry out prudently and diligently. Accordingly, directors are subject to a duty of care, meaning they must carry out the company's business with the caution and care expected from a 'prudent businessman'.

As a general rule, a company's directors are not personally liable for acts performed on the company's behalf, if the acts comply with applicable laws and the company's articles of association. In other words, a director's liability is based on 'fault', defined under Turkish law as willful misconduct or negligence. Therefore, companies' directors and managers are liable to the company, its shareholders and creditors if they breach applicable laws and articles of association.

The directors' duty also applies in relation to transactions between companies in the same corporate group, i.e., a director must continue to act diligently, prudently and in good faith for the benefit of the company of which he or she is a director even when that company is transacting with another company within its corporate group.

Because financial assistance by a joint stock company is prohibited by law, a director of a joint stock company who approves a financial assistance transaction in breach of the Commercial Code would be liable for any company losses arising from that transaction.

### 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

Under Turkish law, it is a general rule that creditors do not have priority over each other and the concept of subordination is not governed under insolvency legislation. However, secured creditors will have priority in relation to the sale proceeds of the secured assets in the event of insolvency, and will receive those proceeds, up to the amount owing to them in priority to unsecured creditors. If the sale proceeds of the secured assets fall short of covering the amount owing to the secured creditor the secured creditor will be entitled to claim this outstanding amount with all other creditors, without having any priority.

The priority of claims among unsecured creditors is complex under Turkish insolvency laws and must be analyzed on a case-by-case basis. However, some receivables take priority over others (e.g., employee payments, debts of the employers to the employee pension funds, alimony payments and public receivables such as tax or social security premium payments).

Finally, secured and unsecured creditors will rank ahead of any return on equity to the shareholders.



## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

### Tax considerations on an acquisition

The fund needs to consider the tax implications at every stage of the buyout, such as:

- (a) the tax burden of acquisition financing, as loans derived from financial institutions are more advantageous compared to those from non-financial institutions as explained below:
  - (i) 10% withholding tax is applicable for the interest payments extended to non-financial institutions, while interest payments extended to financial institutions abroad are subject to 0% withholding;
  - (ii) interest payments extended over loans that are derived from a non-financial corporation that is resident abroad are subject to reverse charge VAT at a rate of 18%, while interest payments extended to financial institutions abroad are exempt from VAT; and
  - (iii) loan agreements concluded with non-financial institutions abroad are subject to stamp duty at 0.948%, while loan agreements executed with financial institutions (both domestic and foreign) are exempt from stamp tax;
- (b) the tax treatment of the interest charges arising on any acquisition finance;
- (c) the tax treatment of dividends (domestic rate is 15%, but some tax treaties provide reduced rates of between 5%-10%);
- (d) stamp duty (at the rate of 0.948% assessed on the agreement value) applicable to each original agreement signed within the context of the buyout. The total stamp duty arising from each document will be subject to a ceiling to be determined on an annual basis (Art. 14, Stamp Duty Law. The maximum stamp duty that can be paid for one document is TRY 1,702,138 for 2015); and
- (e) ensuring any exit occurs on a tax-efficient basis for the fund and management.

### Thin capitalization

Turkish thin capitalization rules provide the debt/equity ratio for thin capitalization as 3:1. Thin capitalization is only relevant in the case of loan transactions between the shareholders and their related parties. The portion of the total loan transactions conducted between shareholders and the related parties that exceed three times the equity capital of a company is considered to be disguised capital, if the other conditions are also fulfilled. Therefore, the interests, foreign exchange differences and other similar expenses calculated over this outstanding total are treated as non-deductible expenses.

### Transfer pricing

The transfer pricing provisions incorporate the arm's length principle. In a transaction for the sale and purchase of goods and services between related parties, a price is considered to be at arm's length if the price is such that the parties to the transaction could have reasonably agreed to the price, had they been unrelated. As an OECD member, Turkey's transfer pricing rules generally follow OECD Transfer Pricing Guidelines.

## Tax consequences on a sale of shares

As a general rule, the gain earned by a company from the sale of shares is subject to corporate income tax at the standard rate of 20%. If the shares have been held for at least two years, however, 75% of the gain from the sale can be exempted from corporate income tax if:

- (a) funds for the sale price are received before the end of the second calendar year following the year on which the sale occurred;
- (b) that portion of the gain benefiting from the exemption is maintained in a special reserve account on the balance sheet for five years; and
- (c) the selling company's main field of activity is not the trading of securities.

If the shares in a joint stock company are issued and held by an individual for more than two years, however, the gain is not subject to income tax. Otherwise, it will be subject to income tax at a varying rate between 15% and 35%. This exemption does not apply to the transfer of the participatory shares in limited liability companies.

## 21. What forms of exit are available?

The most common form of exit for private equity funds in solvent situations is a simple share transfer to either a strategic investor or another private equity fund. This exit procedure may be in the form of one-on-one negotiations with a specific buyer, or an auction between more than one potential buyer. Another option for an exit is a public offering. Turkish law offers the necessary infrastructure for exits through public offerings and private equity funds usually reserve this as a safety net for their exit in shareholders agreements.

Dual track exits are also common in the Turkish market. Depending on the attractiveness of the target, the seller may carry out negotiations with the potential buyer on an exclusive basis or run an auction. Sellers may also prefer to pursue dual track processes where they may opt for a public offering or a block sale at the end of the process.



## Ukraine

### 1. What structures do private equity funds typically use to manage their funds?

Private equity funds in Ukraine are typically set up in the form of a limited partnership registered outside of Ukraine, for example in Delaware, the Isle of Man or the Cayman Islands.

The fund manager is also usually set up outside of Ukraine.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in Ukraine?

An investment fund registered in Ukraine is required to appoint a professional asset management company (**PAMC**). The PAMC must be a Ukrainian company which operates on the basis of a license issued by the National Securities and Stock Market Commission of Ukraine (**NSSMC**). It is a pre-condition to the issue of the license that the PAMC is a member of at least one association of professional stock market participants. An application for the license from the NSSMC is then made by that association on behalf of the PAMC. (The Ukrainian licensing requirements, in particular the requirement for an asset management company of an investment fund to obtain a license from the NSSMC, do not apply to funds registered outside of Ukraine).

The terms of the NSSMC's license require, in particular, that the paid-in share capital of a PAMC is at all times no less than seven million Ukrainian hryvnias (or approximately USD 450,000) and that the PAMC employs at least three certified asset management professionals. Within three months of receipt of the license, the PAMC must also be included in the register of financial institutions maintained by the NSSMC. The NSSMC's license is not limited in duration and remains valid unless revoked.

Investment funds themselves are also registered by the NSSMC in a separate register.

In some sectors only, a license from the state authority that regulates the financial services market (**Financial Services Commission**) is required for managing certain types of assets. This is primarily relevant to private pension funds and real estate funds. The manager of any fund of this type is not regarded to be a PAMC within the meaning of Ukrainian law and does not need a license from the NSSMC. Instead it is licensed by the Financial Services Commission as a provider of financial services. By way of example, a license from the Financial Services Commission is required for a company to raise funds for the purposes of financing construction projects and/or investing in real estate. A provider of this type of financial services is, among other things, required to have an equity capital of at least five million Ukrainian hryvnias (or approximately USD 320,000) and to comply with various capital adequacy requirements. A license to raise funds for the purposes of financing construction projects and/or investing into real estate is issued for five years.

### 3. Are there any approvals required for investments by foreigners in Ukraine and, if so, what is the process?

In general, a foreign investment in Ukraine does not require any approvals or licenses. Instead, there are general requirements to obtain an approval or a license for certain activities or specific transactions that apply equally to foreign and local investors (e.g., a merger clearance or a banking license). One notable exception is the requirement to obtain prior approval of the National Bank of Ukraine (**NBU**) for the establishment of a commercial bank with foreign capital, or for the conversion of an existing Ukrainian commercial bank into a bank with foreign capital.

However, the foreign investment laws of Ukraine do envisage registration of foreign investments with the state authorities. The registration is not mandatory but it gives certain statutory protections to

foreign investors, including protection against nationalization of their investments in Ukraine and a guarantee of unhindered and immediate repatriation of their profits on payment of all taxes. The following documents are required to apply for the registration:

- (a) a foreign investment notice in the prescribed form marked by the local tax authorities of Ukraine to confirm that the investment has actually been made;
- (b) confirmation of the form of the investment (e.g., constituent documents of the Ukrainian company in which the foreign investment is made, a joint activity agreement or a concession agreement); and
- (c) confirmation of the value of the foreign investment.

The state registration authority is required to register the foreign investment within seven business days from the date when the documents are submitted. Registration may only be refused if the application does not comply with the requirements of the law.

There are some restrictions applicable to foreign investors, mainly when it comes to purchasing land or acquiring a stake in a company doing business in certain sectors although these restrictions are very few. For example, foreigners may not own agricultural land in Ukraine and a foreign investment in the share capital of a publishing house may not exceed 30%. There is currently no limit on foreign capital participation in a Ukrainian commercial bank (in the past, there was a limit of 35% of the share capital).

#### 4. Who are the relevant regulators in Ukraine and how much interaction would one generally expect when undertaking a buyout?

##### General

As most buyouts occur using an offshore holding company (which is therefore largely outside of the jurisdiction of the Ukrainian regulators), interaction with the Ukrainian regulators is normally limited. More interaction would be expected with respect to buyouts relating to certain sectors such as banking or other financial services. Generally speaking, the Ukrainian regulators are more relevant where the investment is made directly in a Ukrainian business (and not via an offshore holding company).

##### Merger clearance from the AMC

In a buyout context, the most relevant regulator is the Antimonopoly Committee of Ukraine (**AMC**). The AMC issues merger clearances for the acquisition, direct or indirect, of shares or participatory interests in a company that results in the buyer acquiring or exceeding 25% or 50% of the voting rights in the company. Clearance is needed each time one of the individual thresholds is exceeded. A prior merger clearance from the AMC is required for the acquisition if the monetary or market share thresholds set out below are met.

The monetary thresholds, which currently remain quite low, are as follows:

- (a) total worldwide assets or sales of all parties to the transaction (together with their related parties) are more than EUR 12 million for the previous financial year;
- (b) total worldwide assets or sales of at least two parties to the transaction (together with their related parties) are more than EUR 1 million for the previous financial year; and
- (c) total assets or sales in Ukraine of at least one party to the transaction (together with its related parties) are more than EUR 1 million for the previous financial year.

All three monetary thresholds have to be met for a merger clearance to be required.



Irrespective of whether or not the monetary thresholds are met, a prior merger clearance from the AMC is required if the market share of any party to the transaction or the combined market shares of all parties exceeds 35% of the market. Interaction with the AMC would normally occur only during the stage at which a merger clearance is being obtained.

## Other regulators

### *NBU*

Regulators other than the AMC may also be relevant depending on the sector in which the target business operates. For example, a prior approval of the NBU is required for anyone (both Ukrainian residents and foreigners) to acquire, directly or indirectly:

- (a) 10% or more;
- (b) 25% or more;
- (c) 50% or more; or
- (d) 75% or more,

of shares or voting rights in a commercial bank (each time the relevant shareholding reaches one of these thresholds, a new approval must be obtained). The NBU is required to make a decision within three months from the date of receipt of all of the required documents. If within that time the NBU does not reject the application, approval is deemed to have been granted.

### *FSC*

If the investment is made into a financial institution other than a bank (e.g., a factoring business or an insurance company), the National Commission Exercising State Regulation in the Financial Services Markets Area (**FSC**) is relevant. Like the NBU and its approval of investments into banks, the FSC issues approvals for the acquisition, directly or indirectly, of 10% or more, 25% or more, 50% or more and 75% or more of shares or voting rights in a financial institution other than a bank.

### *NSSMC*

If the target is a joint stock corporation (**JSC**) and the investment is made directly in the capital of that JSC, a high level of interaction with the NSSMC should be expected, in particular, because of the various procedural rules regarding registration of the change in the ownership of the JSC. For this reason, it would be quite rare for a buyout to be structured as a direct investment (direct investment means an investment by a Ukrainian company so that the Ukrainian company is the Holdco).

### *Tax*

No interaction with the Ukrainian tax authorities would normally be expected in a buyout context.

## 5. How are buyouts typically undertaken in the private and the public markets?

A classic leveraged buyout structure is rarely used by private equity funds investing directly in Ukraine. A private equity investment is typically structured as an investment in an offshore company acting as the holding company of the Ukrainian business. If necessary, a pre-acquisition restructuring takes place to set up the appropriate Holdco structure immediately before the transaction starts or before it completes.

Alternatively, an investment is made in a Ukrainian LLC through a Ukrainian special purpose vehicle (SPV) set up by the fund for this purpose (though this is less common). It is more common for private equity funds to acquire a minority interest in Ukrainian businesses rather than a controlling interest. It is not common for the investment to be leveraged.

A typical private equity investment is a privately negotiated transaction governed by English law. It is also common for the seller to run an auction process, especially for the larger assets. A large transaction (which in the Ukrainian market would be a transaction with a value of more than USD 100 million, as a rough guide) normally involves a large number of advisors including English lawyers and investment banks. These transactions tend to have a lengthy negotiation stage at which it is not uncommon to sign a term sheet, a letter of intent or a similar document. The parties are at that stage bound by non-disclosure agreements and/or exclusivity arrangements. Negotiations are primarily centered on the sale and purchase agreement or subscription agreement and the shareholders agreement, all governed by English law. A short-form sale and purchase agreement governed by Ukrainian law is often entered into for Ukrainian purposes and in that case, the English law sale and purchase agreement acts as an umbrella or master agreement. No notarization or apostille is required.

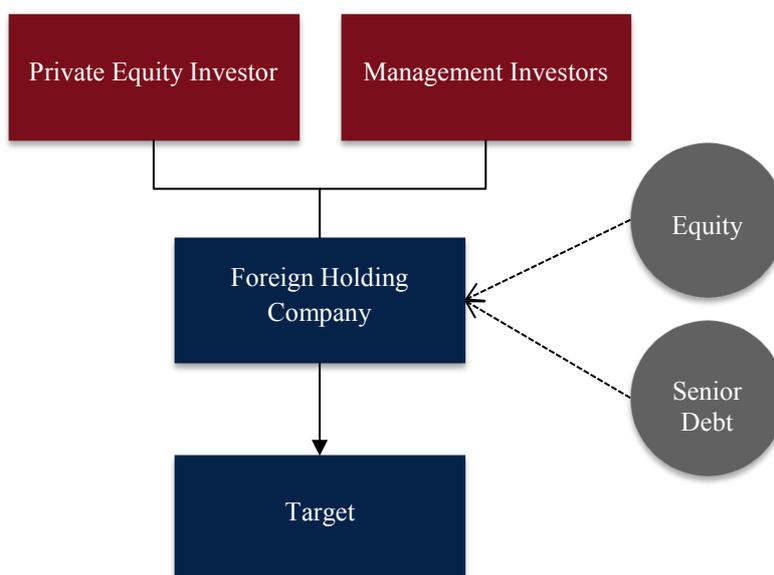
In most cases, a money escrow and/or a documentary escrow arrangement is put in place. Closing of the transaction in most cases takes place in a number of jurisdictions or places at the same time, primarily in the jurisdiction of the offshore holding company (e.g., Cyprus) and in Ukraine. The transaction documents often need to be prepared and entered into in both English and Ukrainian.

It would be very rare for a private equity investment to be structured as a buyout of a public company listed in Ukraine as the Ukrainian stock market is not a developed market.

## 6. What is the typical corporate structure used when doing a buyout?

The corporate structure is usually very simple (please see the answer to question 5).

Finco/Holdco structures are not common as there is usually no debt component to transactions in Ukraine.



The equity investment is made into an offshore holding company (which can be an existing holding company of the Ukrainian business or a new company established in the course of a pre-acquisition restructuring (or simply in preparation for the sale before the start of the sale process)). It is this offshore holding company that is governed by the shareholders agreement to be entered into by the parties. The holding company is very often a Cypriot private company limited by shares. One of the key reasons for the popularity of Cyprus as the jurisdiction of choice for holding companies of Ukrainian businesses is its Western style, English law based legal system. Unlike the Ukrainian legal system that usually does not recognize or allow the use of some popular legal concepts (such as drag along rights, veto rights or warranties), the laws of Cyprus generally make the use of these concepts



possible. Another major reason for choosing Cyprus is the protections offered by the double tax treaty between Cyprus and Ukraine.

An alternative corporate structure is where a special purpose acquisition vehicle (**Acquisition Company SPV**) of the fund invests directly in the Ukrainian LLC or JSC. In that case, the Ukrainian Acquisition Company SPV and target company is typically in the form of a limited liability company (**LLC**) or a joint stock company (**JSC**). Both these types of companies are based on the principle of limited liability for their members.

### LLC

An LLC is legally similar to a German GmbH and a French *société à responsabilité limitée* (SARL). The investors in an LLC are referred to as participants and their participatory (that is, ownership) interests in the LLC are expressed as percentages of the LLC's charter capital. Participatory interests in an LLC do not qualify as 'securities' for the purposes of Ukrainian securities law which means that an LLC is less regulated than a JSC. An LLC can be established either by a single founder or by a group of founders but it cannot be a wholly-owned subsidiary if its sole participant is a wholly-owned subsidiary itself. This is because a person (including a legal entity) is not allowed to be the sole participant in more than one LLC in Ukraine. Currently, there are no minimum capitalization requirements for an LLC.

### JSC

A JSC is very similar in form and operations to a U.S. corporation, German AG and French *société anonyme* (SA). A JSC is a company whose charter capital is divided into shares of equal par value. A JSC can be private or public and any issue of shares by a JSC (including a private JSC) must be registered with NSSMC. The level of supervision of JSCs by the NSSMC is quite high. A JSC can be established either by a single founder or by a group of founders but, similarly to an LLC, a JSC cannot be owned by a single shareholder that is a wholly-owned subsidiary itself. This is because a person (including a legal entity) cannot be the sole shareholder (or participant) of all of the shareholdings in a JSC. There is currently a minimum capitalization requirement for a JSC of approximately 1.5 million Ukrainian hryvnias (or, as at September 2014, approximately USD 100,000).

## 7. What transaction documentation is usually prepared when undertaking a buyout?

The transaction documents that are usually prepared include those set out below.

### Non-disclosure agreement

The non-disclosure agreement is between the seller and the buyer (or a number of buyers). The non-disclosure agreement may include an exclusivity clause. Once this agreement is signed, the pre-acquisition due diligence goes to the second, in-depth stage.

### Term sheet or letter of intent

Though not a binding-document, this document can be the subject of a heated debate. Term sheets range from very short and simple documents setting out the key details of the commercial agreement that are prepared with limited involvement of lawyers to more sophisticated and longer form documents.

### Shareholders agreement

The shareholders agreement is most likely to be governed by English law. The shareholders agreement is usually a sophisticated document containing, in particular, various veto rights, pre-completion covenants, detailed governance provisions, detailed provisions in relation to transfers of shares in the company, corporate governance rules for the Ukrainian subsidiaries and exit rights. To

the extent permitted by law in each relevant jurisdiction, the key provisions of the shareholders agreement are then incorporated into the new (that is, adopted at completion of the acquisition) constituent documents of the target group companies (e.g., articles of association).

### Sale and purchase agreement

Like the shareholders agreement, this is normally a long-form document governed by English law. It usually contains comprehensive warranties and/or indemnities. Tax indemnity provisions are either included in this document or in a stand-alone tax indemnity deed and retention of a portion of the purchase price is common.

### Disclosure letter

A well-advised seller would prepare a disclosure letter to qualify the warranties included in the sale and purchase agreement.

### Escrow agreement

It is more common than not to have a monetary or a documentary escrow arrangement (or a combination of the two) put in place. A portion of the purchase price or the entire purchase price is often deposited with an escrow agent (typically, a bank). Certain key ancillary documents such as share transfer forms signed by the seller can also be put into an escrow agreement (typically, with a law firm).

### New articles of association (or their equivalent)

These would be adopted for the target group companies at closing of the transaction.

## 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

### Due diligence of the target company

At the outset of the transaction, risks are mitigated by the buyer through an in-depth due diligence of the target company. The due diligence normally includes legal, financial and tax due diligence and the due diligence findings then translate into the transaction documentation, primarily the sale and purchase agreement, in the form of specific warranties, conditions precedent and indemnities. The process also helps to structure the transaction in a way that minimizes risks for the buyer (e.g., an entity with significant potential liabilities can be excluded from the target group or a share deal can be turned into an asset deal). Finally, the buyer can use the due diligence findings to reduce the purchase price.

### Sale and purchase agreement

The sale and purchase agreement gives the buyer a number of contractual protections. First of all, the buyer is given warranties in relation to various matters about the business. A private equity buyer is usually able to negotiate a set of warranties that go beyond title and capacity warranties although this, of course, depends on the strength of the negotiating position of the buyer. A well-advised seller would attempt to qualify its warranties in a disclosure letter. The disclosure letter process is another opportunity, albeit not a very welcome one at this stage in the transaction, to uncover issues in relation to the business. Secondly, it is common for the seller to give a tax indemnity and also for the buyer to seek indemnities in relation to other matters where appropriate.

The buyer can also seek the inclusion of conditions precedent in the sale and purchase agreement such as regulatory approvals, no material breach of warranties before completion and certain problems with the business having been fixed by the seller. Warranty & indemnity insurance is available in principle in the Ukrainian market, but in practice it is very rare.



A material adverse change clause is not uncommon, and its precise wording depends on the amount of leverage that the buyer has in the negotiations. In addition, the purchase price is typically paid in instalments, with the first instalment payable at completion of the transaction and the remaining instalments being conditional on the occurrence of certain events (e.g., a new license being granted or a construction being completed). Finally, the buyer can request that a company or an individual related to the seller guarantees the performance by the seller of its obligation, which can be particularly useful when the seller needs to pay under a warranty or indemnity claim. The guarantee can also be a stand-alone document.

### Escrow arrangements

Apart from contractual protections under the sale and purchase agreement (which vary from deal to deal), there are some other mechanisms to protect the buyer. One of them is an escrow arrangement where the entire purchase price (or a portion of it) is held by an independent agent to be released on the occurrence of specific events. If the purchase price is paid in instalments, the later instalments can be retained in an escrow account. The purchase price itself can be subject to adjustments (e.g., a working capital adjustment) which means that if the buyer paid in excess of the value of the business at completion, the buyer can have a portion of the purchase price returned to it.

### Shareholders agreement

Following completion of the transaction, the buyer can expect protections under the shareholders agreement such as veto rights. These protections are most readily available in the jurisdiction of the holding company (which would usually be incorporated outside Ukraine). One way to extend the application of the shareholders agreement protections to the jurisdiction of the subsidiaries is to align the corporate governance of the subsidiaries with the shareholders agreement. In particular, this can be done by mirroring the provisions of the shareholders agreement in the constituent documents of the subsidiaries (to the extent permitted by the law of their respective jurisdiction). Some (but not all) provisions are capable of being reflected in the jurisdictions of the subsidiaries. In addition, the new constituent documents of the subsidiaries adopted at completion of the transaction can also include certain provisions to protect the buyer (such as limitations on the authority of the local directors and signatories under the banking documents).

## 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

There are no specific laws regulating conflicts of interest in a typical management buyout in Ukraine. Statutory provisions in relation to matters that in other jurisdictions are referred to as fiduciary duties are quite limited in general under Ukrainian law. The bulk of obligations and rules of conduct for directors and officers would normally be contained in the company's internal regulations and policies and in the employment, or other, agreement with the individual director or officer. In particular, one would expect these documents to require directors and officers to act in good faith and in the best interests of the company, to be loyal to the company, not to place themselves in a position of conflict and to disclose any personal interest in any proposed transactions. Confidentiality undertakings are very common in employment and other agreements between companies and their officers. The law also requires officers of LLCs and JSCs to maintain in confidence all confidential information and commercial secrets of the company.

Recent changes to the law have introduced some elements of fiduciary duties and they apply to officers of JSCs. Officers of JSCs are now required by law to act in the interests of the company. Further, an officer with an interest in a transaction is under an obligation to disclose that interest to the company within three business days from the date the interest arose.

## 10. How are the equity arrangements typically regulated in a buyout?

The equity arrangements are included in the shareholders agreement among all persons that will hold shares in the company following completion of the acquisition and the company itself. The relevant provisions of the shareholders agreement are normally mirrored in the new constituent documents of the holding company (usually an offshore entity) and, to the extent that Ukrainian law allows, are also mirrored in the constituent documents of the operating Ukrainian companies.

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

The Ukrainian corporate laws do not allow much 'rights tailoring' for either JSCs or LLCs.

JSCs may issue ordinary shares and preferred shares of various classes, all of which can only be issued as registered shares in book-entry form. Preferred shares can be issued as non-voting shares (except that a holder of preferred shares has the right to vote on matters concerning his or her class rights). However, there are various statutory rules that significantly limit 'rights tailoring'. For example, the law does not allow restricting the number of shares, or the number of votes attaching to shares, held by a shareholder. Preferred shares may not exceed 25% of all shares issued by the company. The law expressly regulates matters such as quorum and voting at shareholders' meetings (the statutory quorum for a shareholders' meeting is set at 60% of all voting shares).

When it comes to LLCs (which are generally simpler to run and more flexible type of legal entity), there are no legal restrictions in relation to how the participatory interests in an LLC are distributed. This allocation is done at the discretion of the founders of the LLC. However, each participant has voting rights in proportion to the percentage of the charter capital of the LLC that that participant holds. The quorum for meetings of participants is set by law and equals 60% +1 vote of all votes.

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

### Board constituency

Legal entities cannot act as directors, and all directors must be resident in Ukraine. LLCs and JSCs can have a sole director or a board of directors, in each case appointed by the participants of the LLC or the shareholders of the JSC (directly or through the supervisory board, if applicable). Directors are generally appointed and removed by a simple majority vote. The composition of the board of directors (including in relation to the number of directors) and the appointment of directors are regulated by the constituent documents of the company.

### Differential director voting rights

Usually, each director has one vote and decisions of the board of directors are passed by a simple majority of votes. The law largely leaves it to the shareholders to agree how directors vote and to reflect that agreement in the constituent documents of the company.

### Removal of directors

Removal of a director is primarily regulated by his or her employment or other agreement with the company. This agreement typically allows the shareholders to remove the director at any time. If there is no written agreement with the director or no removal provisions in his or her agreement, the shareholders can remove the director (by a simple majority vote) at any time because the law now gives the shareholders the right to do so. If this happens, the director will be entitled to a severance payment that cannot be less than six months' average remuneration of that director.



### 13. What measures are commonly used to give a private equity fund some level of control over key operating and financial decisions made by a portfolio company?

At the level of the offshore holding company, the measures typically include director appointment rights and various veto rights in relation to material operating and/or financial decisions at each level in the target group. The fund is also likely to request extensive information rights to be included in the shareholders agreement, such as the right to receive regular financial reports and/or other financial information about the group and to have access to the employees and/or the premises.

At the level of Ukrainian subsidiaries, a number of measures are available. All key operational and financial decisions can be reserved to the shareholders and therefore, the management of the Ukrainian subsidiaries cannot make these decisions without the prior approval of the shareholders. It is also possible to limit the directors' authority in the constituent documents (e.g., to introduce monetary caps for transactions that the directors are authorized to decide on their own). Various options are also available when it comes to the signing of documents on behalf of the Ukrainian subsidiaries. The signing powers can be delegated to a person who is not a director or a requirement for a joint signature by a director and a representative of a shareholder can be stipulated in the constituent documents.

### 14. What employment terms are generally imposed on management in a buyout?

The employment terms of management of Ukrainian subsidiaries are largely determined by the Ukrainian employment laws which are traditionally very employee-friendly and accordingly do not allow much flexibility. Generally, the employment terms of the Ukrainian managers may not deprive them of the rights and benefits that are guaranteed by the labor laws of Ukraine. A good example of an employment term that is problematic from the point of view of Ukrainian law is non-compete restrictions. Non-compete restrictions are usually unenforceable in Ukraine.

The terms of employment or other engagement of senior management would normally be documented in foreign-law governed agreements with the offshore holding company. These agreements typically include leaver provisions, non-compete restrictions and/or incentive arrangements (unless included in the shareholders agreement). It is also common to have a stand-alone incentive arrangement with a manager, which is usually cash-based (rather than in the form of equity). The most common form is a bonus plan which provides an incentive for the achievement of certain KPIs and provides for a cash payment on exit from the investment.

### 15. What equity incentives can be offered to management and how are they typically structured?

It is not common to have any equity-based incentives at the level of Ukrainian subsidiaries. These arrangements would normally be documented in a foreign-law governed agreement (see the answer to question 14).

### 16. How are buyouts typically debt financed and secured?

Please see the answer to question 5. The use of borrowed money is not common.

### 17. Are there financial assistance issues to consider when undertaking a buyout?

A Ukrainian JSC is prohibited from giving financial assistance to a person for the purpose of acquiring shares in that JSC. This extends to giving security under loan agreements entered into for

the purpose of acquiring shares in that JSC. Ukrainian law does not currently provide any exceptions to that rule or for a whitewash process. If a JSC nonetheless gives financial assistance to a buyer of its shares, the acquisition of the shares may be invalidated in court.

No equivalent prohibition exists in relation to LLCs.

The availability of financial assistance in the jurisdiction of the offshore holding company is determined by the laws of that jurisdiction.

## **18. What are the implications under the corporate benefit laws of Ukraine for a company providing financial assistance?**

There are no specific sanctions or implications under Ukrainian law in relation to financial assistance and corporate benefit. If notwithstanding the prohibition against the giving of financial assistance in relation to a JSC, the JSC provides financial assistance, the sale and purchase agreement would be contrary to law and therefore the acquisition of shares could be held to be invalid by the court.

## **19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?**

Secured creditors generally rank ahead of unsecured creditors and both secured and unsecured creditors generally rank ahead of shareholders. In the course of the liquidation proceedings of an insolvent company, the assets over which a security interest was established are dealt with separately and used to satisfy claims of the secured creditors. The remaining assets are pooled together and sold to satisfy claims of all other creditors in the order of priority set out in the insolvency laws. In particular, salaries and other amounts payable to employees and costs of the liquidation proceedings, followed by taxes, rank ahead of other unsecured claims. Any assets remaining after the satisfaction of claims of all creditors are returned to the 'owners' of the debtor (i.e., shareholders in a JSC or participants in a LLC) if the court decides to dissolve the debtor.

A special order of priority of satisfaction of creditors' claims is required for certain categories of debtors (including banks, insurance companies and investment funds). These include enterprises that:

- (a) have particular value to the local community;
- (b) employ 50% or more of the population of the town or other administrative unit;
- (c) employ more than 5,000 persons; or
- (d) are involved in the mining, chemical or oil industries,

liquidation of which requires taking of measures to prevent adverse impact on the population or the environment (as the case may be). In the liquidation proceedings these enterprises are required to be sold as a whole (i.e., in the form of the so-called 'integral property complex'). Liquidation of agricultural companies must account for the seasonality of their business, particularly with regard to possible satisfaction of creditors' claims using the future harvest.

## **20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?**

The corporate structure generally needs to be decided with tax implications in mind, especially given the presence of an offshore holding company and/or other offshore entities in the group structure.

One of the key considerations in deciding on the structure is the availability of protection under double tax treaties of Ukraine with other countries. The tax treatment of dividends, royalty payments, interest payments and sale proceeds on an exit varies depending on the jurisdiction of the offshore



holding company and/or the payee. Ukraine is a party to nearly 70 double tax treaties, in particular with Cyprus, the Netherlands and Austria.

## 21. What forms of exit are available?

The most common avenues of exit in a solvent situation are a trade sale and an IPO on a recognized stock exchange (e.g., in Warsaw). Dual track sale processes are not common in Ukraine.

The availability of exit may generally be quite limited at times of volatility in the Ukrainian market.

It is important to reach some agreement over the timeline and forms of exit at the beginning of the investment process and document the agreement (e.g., in the shareholders agreement).

## United Arab Emirates

### 1. What structures do private equity funds typically use to manage their funds?

#### Background

The United Arab Emirates (UAE) is a country that is a federation of seven emirates that includes Dubai and Abu Dhabi (the capital). Within the UAE there are almost 40 different ‘free zones’ which are geographical areas each focusing on a particular business area/industry. For example there are ‘free zones’ covering healthcare, commodities, biotechnology, media, internet and finance/banking/insurance.

The Dubai International Financial Centre (DIFC) is the ‘free zone’ dealing with finance, banking and insurance. It has its own legal regime (based on English common law) separate from the legal regime of the UAE. Many multi-national financial institutions have a presence in, and operate from, the DIFC. However, downstream investments by private equity funds into DIFC companies are not common.

In the ‘free zones’ 100% foreign ownership of businesses is permitted. In the UAE generally (i.e., outside of the ‘free zones’) the maximum foreign ownership of companies is 49%.

#### Structures

Most UAE private equity funds use an offshore structure set up through a limited partnership in countries such as the Cayman Islands or the British Virgin Islands. It is possible to set up a fund in the DIFC but the process is heavily regulated and even those financial institutions that do operate from the DIFC, tend to favor offshore fund structures rather than elect to establish the fund in the DIFC. Very few funds have decided to move away from tried and tested locations outside the UAE, which are usually much cheaper than the DIFC. In addition, there may be greater perceived country and regulatory risk in the UAE.

Some UAE and Middle East private equity funds have been set up using vehicles incorporated or registered in Bahrain, principally to allow the fund to be Gulf Co-operation Council (GCC) domiciled. This can mitigate the issue that non-GCC entities face with foreign ownership restrictions in the UAE and GCC states.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in the United Arab Emirates?

#### UAE

The offering and sale of interests in foreign private investment funds in the UAE are subject to regulation by the UAE Securities and Commodities Authority (ESCA). Under the Investment Fund Regulations, foreign fund sponsors are generally required to obtain ESCA’s approval and appoint a locally-licensed placement agent in connection with offerings of fund interests in the UAE. An exemption from these requirements is available, however, in relation to offerings limited exclusively to:

- (a) exempt investors in the UAE; and
- (b) offerings conducted on a ‘reverse inquiry’ basis.



### *Exempt investor*

A foreign fund that promotes the sale of fund interests to certain categories of investors within the UAE falls entirely outside the scope of the Investment Fund Regulations. These categories of investors include:

- (a) authorities and governments (UAE federal and Emirate-level);
- (b) institutions whose main purpose include ‘investments in securities’; and
- (c) investment managers who have authority to make investment decisions on behalf of their clients.

An institution or entity whose main purpose is ‘investments in securities’ is exempt from the Investment Fund Regulations if the institution or entity invests only for its own account and not on behalf of its clients. Notably, while the Investment Fund Regulations do not define the term ‘institution’, ESCA has indicated that this term includes any entity other than an individual.

For offerings of interests in foreign funds limited exclusively to the above categories of investors in the UAE, approval by ESCA is not required and there is no requirement to appoint a local placement agent.

### *Reverse inquiry exemption*

ESCA has confirmed publicly that dealing with UAE investors on a ‘reverse inquiry’ basis falls outside the scope of the Investment Fund Regulations, although records must be kept as proof that the inquiry originated from the investor.

### *Promotion*

The concept of ‘promotion’ is broadly defined to include any advertising, marketing, offering or distribution of interests in a foreign investment fund. The Investment Fund Regulations do not make any distinction between ‘pre-marketing’ activities (such as providing general information regarding a fund sponsor’s capabilities and experience) and marketing activities focused on a specific fund offering.

## **DIFC**

As stated in the answer to question 1, the DIFC is a ‘free zone’ within the UAE and has its own laws and regulations. A large majority of private equity businesses in the UAE operate from the DIFC. Funds set up in the DIFC (domestic funds) must appoint an operator authorized by the Dubai Financial Services Authority (**DFSA**). Any entity wishing to manage a collective investment fund in the DIFC must usually first become authorized to provide financial services including:

- (a) operating a collective investment fund;
- (b) fund administration; and
- (c) asset management.

The DFSA authorization criteria are likely to be met by institutional firms but smaller and less established promoters and fund managers may find them restrictive and costly.

## **3. Are there any approvals required for investments by foreigners in the United Arab Emirates and, if so, what is the process?**

The UAE imposes restrictions on foreign investors. UAE entities incorporated outside of the free zones are typically required to be at least 51% held by a UAE national or another UAE entity wholly-owned by UAE nationals. This significantly limits the ability of private equity funds to

complete leveraged buyouts or to take control positions in the UAE (as a result of which minority acquisitions or growth capital transactions are more common).

Alternative transaction structures include genuine co-investments with a UAE national or the use of a nominee shareholder (who would be either a UAE national or a UAE corporate nominee service provider (**Nominee**)) to hold 51% of the legal title to the shares on behalf of the foreign shareholder.

The UAE has implemented a policy that permits 100% ownership of UAE companies by individuals or companies from the GCC. This policy is widely adopted, although its precise scope is unclear and it is left to the discretion of the individual corporate registration departments to implement.

A civil company formed under the Civil Code, can be 100% foreign-owned but shareholding in that company is normally limited to individuals (and is therefore of limited application for private equity transactions).

There is ongoing discussion in the market about increasing the percentage of permitted foreign ownership in the UAE, however, this has not yet translated into legislation.

#### **4. Who are the relevant regulators in the United Arab Emirates and how much interaction would one generally expect when undertaking a buyout?**

The involvement of ESCA and the Central Bank (as the case may be) (for entities outside the free zones) or the DFSA (for entities in the DIFC) would in general not be required in relation to any downstream investment.

It is necessary, however, to deal with various government departments and institutions in relation to a transfer of shares. For example, the trade license for a limited liability company (**LLC**) must be amended on a transfer of shares to reflect the new shareholders, and depending on the activity of the company, certain other approvals would need to be obtained from government departments to transfer the shares.

#### **5. How are buyouts typically undertaken in the private and public markets?**

##### **Private market**

The buyout process in the UAE is very similar to that in more developed jurisdictions (i.e., through a private contract following negotiation of its terms between the parties). There is uncertainty in the interpretation and enforcement of UAE law and so it is common for the main transaction documents to be governed by foreign (e.g., English) law. The UAE is a developing market but increasingly investment banks are involved in the sale process and run competitive auctions for assets that are being sold.

If a Nominee is to be appointed to hold 51% of the target company, documentation including a shareholders agreement and partners agreement must be negotiated with the Nominee at the same time as the sale and purchase agreement (or at least prior to the transfer of the shares to the Nominee).

This documentation provides for:

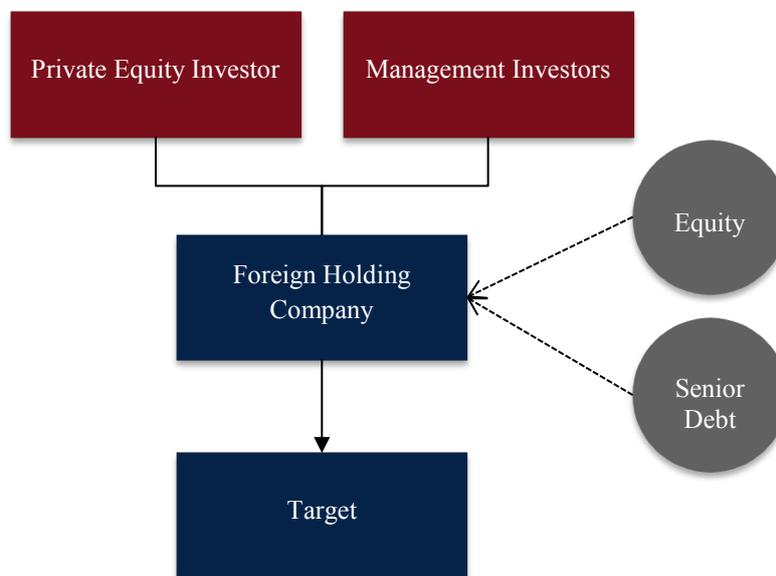
- (a) the economic benefit of the 51% to accrue to the foreign shareholder;
- (b) the foreign shareholder having management control of the target; and
- (c) the ability for the foreign shareholder to require the Nominee to transfer the 51% to another party of the foreigner shareholder's choosing.



## Public market

A public company buyout in the UAE is less common and would require the purchaser to comply with the takeover and disclosure rules of the relevant exchange. There are only a limited number of entities registered on these exchanges and many have significant state or institutional shareholdings. Other factors such as the absence of squeeze-out procedures and the foreign ownership restrictions therefore make public takeovers difficult and therefore uncommon in the UAE.

## 6. What is the typical corporate structure used when doing a buyout?



The choice of corporate structure when undertaking a buyout is often driven by local ownership restrictions. It is common for private equity funds in the UAE to use special purpose vehicles incorporated in offshore jurisdictions to act as the purchasing entity to overcome some of the local law limitations such as the restriction on having only one class of share and the cumbersome and time-consuming process for transferring and issuing shares in the UAE. Offshore jurisdictions also provide more legal certainty and the ability to structure complex equity arrangements among the investors.

Two- or three-tier holding company structures are less common in the UAE than in developed jurisdictions as complex debt structuring is not generally seen in relation to UAE private equity transactions.

## 7. What transactional documentation is usually prepared when undertaking a buyout?

### Corporate

#### *Private companies*

The transaction documentation used for a buyout in the UAE is similar to that used in more developed jurisdictions. Except in the case of an auction process, negotiation usually begins with the circulation of a letter of intent (**LOI**) or memorandum of understanding (**MOU**). While the LOI or MOU is generally stated to be non-binding in nature, the parties usually expect that all the terms contained in the LOI or MOU will eventually be replicated in the formal agreements if the transaction proceeds.

Prior to beginning detailed due diligence and negotiation of contractual terms, a well-advised investor may also request a period of exclusivity, during which the seller cannot ‘shop’ the target. This

arrangement may be included within the confidentiality agreement or in a separate exclusivity agreement. After due diligence in relation to the target company is completed, the share purchase agreement, subscription agreement or investment agreement is executed by the parties. Typically, a shareholders agreement is also entered into by the fund/investor, the target company and the continuing founders/existing shareholder(s). This shareholders agreement is separate and distinct from any agreements entered into with a Nominee.

#### *Public companies*

In the context of buyouts involving public listed companies, additional documentation may be required to effect the takeover bid. The form and content of the relevant documentation depends on, among other things, the legal and regulatory requirements of the target company's place of incorporation and the stock exchange on which its shares are listed.

## Financing

#### *Banking and security documentation*

Where debt is used, the main banking document is the facility agreement under which the terms of the loan made to the purchaser are documented. Typically, separate security documents are executed by which the target company provides security for the loan granted to it. The nature of the security depends on the circumstances. If there are different debt providers, their respective positions would depend on subordination and other contractual arrangements negotiated among the parties. Where there are different types of debt finance, subordination is typically implemented through an intercreditor agreement.

#### *Shari'a compliance*

Some UAE transactions also seek to ensure that their financing is Shari'a compliant. Shari'a compliant structures can include different types of Islamic financing such as Ijarah or Murabaha. This typically involves a master agreement, security documentation and separate agreements to comply with the relevant type of Islamic financing, such as agency agreements, promises to sell and promises to buy.

## 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does protection come from?

Private equity investors in the UAE usually benefit from a customary suite of deal protections often seen in more developed jurisdictions. These include:

- (a) warranties and indemnities from the sellers and/or management;
- (b) pre-completion covenants;
- (c) retentions;
- (d) escrow accounts;
- (e) completion accounts;
- (f) locked boxes; and
- (g) restrictive covenants.

Warranty & indemnity insurance is becoming more available in the UAE market, although it is still not commonly used.



## 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

Under UAE companies law, directors have various obligations to the company, its shareholders and third parties. These duties include, without limitation, directors being required to immediately inform the board if a conflict of interest arises. In those circumstances, a director is then not permitted to vote on any board decisions relating to that matter.

Transaction/management protocol letters are generally not used.

## 10. How are the equity arrangements typically regulated in a buyout?

As UAE law does not permit different share rights, equity arrangements are not usually structured in relation to a UAE company. In an acquisition in the UAE, it is common for the private equity fund to put in place an offshore special purpose vehicle that would be able to have different share rights and be structured in such a way so as to accommodate the complex equity arrangements common in private equity transactions.

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different shareholders?

UAE law generally only permits one class of ordinary shares and 'rights tailoring' is not generally possible among different shareholders.

A private equity investor therefore cannot be issued with convertible shares and/or preference shares and must seek alternative contractual rights and protections through the articles of association or the shareholders agreement. It is very difficult for a UAE LLC to issue convertible notes or other synthetic equity. For these reasons, the equity arrangements are usually put in place using an offshore SPV holding company.

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

Typically, the shareholders agreement sets out the relationships, rights and obligations among the investor, the target company and the existing shareholders of the target company. The shareholders agreement and the articles of association would govern matters concerning board constituency, differential director voting rights and the removal of directors.

It is common for private equity funds to have specific appointment and removal rights in relation to a certain number of directors in their portfolio companies. There is broad flexibility in the UAE in relation to how these arrangements can be structured.

## 13. What measures are commonly used to give a fund some level of control over key operating and financial decisions made by a portfolio company?

LLCs do not always have a board of directors, particularly where a family has controlled the business. This can pose issues for a private equity investor seeking to exert management control over the company other than through provisions in the articles of association and/or any shareholders agreement.

If a board of directors or managers (as applicable) is set up, depending on the level of the investment, the private equity investor will seek to control the board. The concept of certain board and/or shareholder reserved matters is broadly accepted in the UAE and these are set out in the articles of association and/or shareholders agreement.

#### **14. What employment terms are generally imposed on management in a buyout?**

The employment terms generally imposed on management in a buyout depend on the nature of the company and the level of private equity investment. If family members remain heavily involved in the day-to-day management of the company, there may be no formal employment arrangements put in place to regulate their employment. However, where management teams are appointed as part of the private equity investment, employment contracts with standard terms (for example, non-compete and non-solicitation clauses and good leaver and bad leaver terms) are usually put in place.

#### **15. What equity incentives can be offered to management and how are they typically structured?**

UAE LLCs are not permitted to have different share rights. Therefore, it is necessary to put in place arrangements such as phantom share schemes, cash bonuses and other incentive arrangements for portfolio company management. Sometimes managers are offered shares in the portfolio company (or a holding company of the portfolio company) that are the subject of an IPO on an exit.

#### **16. How are buyouts typically debt financed and secured?**

Given the relative infancy of private equity in the UAE, debt is not a common part of any private equity transaction. Where debt is used, usual security and contractual and structural mechanisms (e.g., subordination) are used to protect the lender's investment. This would be the same for Shari'a compliant financing.

#### **17. Are there financial assistance issues to consider when undertaking a buyout?**

On 1 July 2015, a new Commercial Companies Law will come into effect in the UAE that contains a prohibition on financial assistance, with no mechanism for the financial assistance to be authorized (i.e., a whitewash procedure commonly seen in other jurisdictions). As the rules are new and untested, the application of the rules is unclear, including whether they would even apply to LLCs (considered to be unlikely).

#### **18. What are the implications under the corporate benefit laws of the United Arab Emirates for a company providing financial assistance?**

In addition to the potential application of the new rules described in the answer to question 17, the directors of the relevant company need to act in the best interests of the company and in accordance with the objects of the company set out in its constitutional documents. The effect of this is that financial assistance cannot be given unless it is in the best interests of the company.

#### **19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?**

Priority is given to preferential creditors (i.e., essentially employees, tax authorities, other governmental authorities and real-estate mortgage holders). There is little precedent from the UAE courts on this point. However in the case of an insolvent liquidation, debt providers have priority over equity holders. Among debt providers, the order of distribution starts with secured creditors holding a valid and perfected security interest.



## 20. What are the general tax and duty considerations for a fund when undertaking a buyout?

As there is broadly no income or corporate tax payable in the UAE or the DIFC (subject to limited exceptions in the oil and gas and banking sectors) matters of tax are generally irrelevant.

## 21. What forms of exit are available?

All of the customary exit routes are seen in the UAE, being IPO on a recognized local or foreign stock exchange, a sale of the portfolio company to a trade buyer or a secondary sale to another private equity investor. The most common exits to date in the UAE and broader Middle East have been by way of IPO, sale to co-investors or sale to a strategic buyer.

## United Kingdom

### 1. What structures do private equity funds typically use to manage their funds?

Private equity funds are invariably structured so that there is no or minimal tax liability at the level of the fund. This usually results in the fund itself being established as a tax-transparent entity or in a low or zero-tax jurisdiction such as the Channel Islands or the Cayman Islands. The location of the fund assets and the fund's potential investors also has an influence. For example, funds may wish to maximize returns from the fund's investments by reducing the incidence of any withholding taxes. To achieve this, the fund would typically choose a jurisdiction (for example, Luxembourg) that allows both tax-neutral fund structures and also has an extensive network of double tax treaties with countries where investments may be located.

Separate 'feeder' or parallel investment structures may be adopted by certain investors for investing into the fund or the underlying assets in a way that optimizes their own tax position.

#### Legal structures

Legal structures adopted for private equity funds are, typically, limited partnerships or close-ended companies. In each case, the investors are largely passive (either limited partners or shareholders) and the management of the fund assets is conducted, in the case of a limited partnership, by the general partner (or by a fund manager on its behalf) and, in the case of a close-ended company, by a fund manager appointed by the board of directors of the fund. While the fund itself may be established in an offshore jurisdiction, the fund manager is likely to be located in a financial center with access to an appropriate pool of intellectual capital. Alternatively, an offshore fund manager may appoint an affiliated adviser in such a financial center.

In the United Kingdom, in common with certain other jurisdictions, general partners, fund managers and advisers are (subject to compliance with certain requirements) able to manage offshore private equity funds without creating a so-called 'permanent establishment' for the fund in the UK for tax purposes. They therefore avoid the taxation of the capital or profits of the funds in the UK. This has resulted in a high concentration of private equity fund managers and advisers being located in London.

#### AIFMD

Recent regulatory developments in Europe (notably, the implementation of the Alternative Investment Fund Managers Directive (**AIFMD**) (see the answer to question 4 below)) have caused private equity fund managers to reappraise the structures they use for their funds and management/advisory infrastructure.

Generally speaking, it is now more advantageous for a private equity fund manager seeking investors in Europe to establish and seek authorization for its management entity in a member state of the European Union or European Economic Area (EEA) to afford itself the so-called 'passporting rights' for its managed funds. This allows the offering of those funds to European institutional investors with a single regulatory approval (as opposed to seeking approval and/or having to comply with offering restrictions on a country-by-country basis). The marketing passport right is available only to EU-based managers of EU-based funds; non-EU based alternative investment fund managers (AIFMs) will continue to be governed by national private placement regimes until at least 2015. This development has heralded an on-shoring trend amongst managers seeking access to European capital.



## Managers of AIFs

Managers of alternative investment funds (which includes private equity funds) must also comply with the AIFMD. The AIFMD implements European legislation that regulates managers of funds who manage and/or market funds in the EU in relation to professional investors. As well as imposing marketing, transparency, remuneration and structuring obligations on funds, the AIFMD restricts ‘asset stripping’ from portfolio companies. This prohibits funds from making distributions, capital reductions, share redemptions and buybacks in relation to the target company in the first two years following a buyout. This impacts on a number of common private equity structures and should be taken into account at an early stage of the buyout.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in the United Kingdom?

Private equity funds established in low or zero-tax jurisdictions such as the Channel Islands or the Cayman Islands are usually not subject to a high degree of regulatory compliance (if they do not conduct business within the jurisdiction in question). However, tax rulings may be required where the benefit of a double-tax treaty is sought (e.g., for a Luxembourg fund).

The activities of the fund manager are typically regulated in the country in which the fund manager operates. In the UK, the regulation is carried out by the Financial Conduct Authority (FCA) and the fund manager needs the appropriate FCA authorizations for the business it conducts. This includes both the offering of units in the fund to investors and the ongoing management of the fund’s investments. For example, there are restrictions on the types of investors to whom interests in a private equity fund may be offered in the UK, or by a UK fund manager. These restrictions have the effect of preventing offers to people other than those for whom the investments are likely to be suitable (e.g., institutional or corporate investors or, in some circumstances, high net worth or sophisticated individuals).

### 3. Are there any approvals required for investments by foreigners in the United Kingdom and, if so, what is the process?

The United Kingdom has no exchange controls or mandatory foreign investment approvals of general application. Various approvals or notifications may be required in the case of acquisitions in certain fields, such as the banking, utilities, media and insurance sectors. However, these requirements exist principally because of the nature of the business concerned rather than as mechanisms to control foreign investment. For example:

- (a) approval required due to the sector in which the company operates: Certain regulated industries such as defense, media, insurance and banking and financial services are subject to specific rules that may necessitate approval. For example, under the Communication Act 2003, the Secretary of State has the authority to intervene in media mergers where a particular transaction gives rise to public interest considerations;
- (b) competition/antitrust approvals: (i.e., merger control) consent from the UK Competition and Markets Authority or, if the transaction has a community dimension, approval from the European Commission;
- (c) clearance from the Pensions Regulator: where the target company has a defined benefit scheme in place and that scheme is in deficit, a change of control of that target company can trigger obligations in relation to the funding of the defined benefit scheme; and
- (d) consent from HM Treasury: where the proposed transaction would result in a UK resident company either causing a non-UK resident company which it controls to issue securities, or transferring securities in a non-UK resident company which it controls.

## 4. Who are the relevant regulators in the United Kingdom and how much interaction would one generally expect when undertaking a buyout?

### Primary regulators

The primary regulatory authorities in the UK in the context of a buyout include:

- (a) the Financial Conduct Authority (**FCA**) which is responsible for supervising compliance with the Financial Services and Markets Act 2000 (**FSMA**), the UK Listing Authority Rules (which govern companies listed on the London Stock Exchange), and the AIM Rules (for companies whose securities are traded on AIM, the unregulated market of the London Stock Exchange);
- (b) the Panel on Takeovers and Mergers (**Panel**) which oversees compliance with the City Code on Takeover and Mergers (**Takeover Code**); and
- (c) competition authorities - i.e., the UK Competition and Markets Authority and the European Commission.

### Private company buyout

In the case of a buyout of a private company, there would not ordinarily be any interaction with either the FCA (unless the target's business is regulated by the FCA) or the Panel. A possible exception to this rule would arise where, in the last ten years:

- (a) the target has re-registered as a private company having previously been a public company whose shares were listed on the London Stock Exchange (including AIM); or
- (b) the target company has filed a prospectus.

In these circumstances, the Takeover Code still applies to the buyout but the Panel may be willing to apply the Takeover Code more flexibly or, with the consent of all shareholders, to waive compliance with the Takeover Code.

### Public company buyout

In the case of a buyout of a public company, a bidder and its advisers would need to have significant interaction with the Panel throughout the buyout process. Ordinarily there would be no material interaction with the UK Listing Authority/AIM team (other than in relation to the de-listing of the target company's shares) or the FCA, unless the FCA was concerned that the conduct of any of the parties related to the buyout had breached any relevant FSMA provisions.

Other regulatory authorities may also be relevant depending on the nature of the transaction, target and sector. (Please see the answer to question 3).

## 5. How are buyouts typically undertaken in the private and the public markets?

### Private companies

In relation to private companies, a buyout is generally undertaken by way of a private acquisition that is concluded after negotiation between the parties. The parties enter into a sale and purchase agreement that records the terms and conditions of the acquisition as well as the rights and obligations of the parties involved. Frequently, the buyout takes place following an 'auction process' where several competing bidders are invited by the seller to bid for the target company and where the seller ordinarily concludes a sale and purchase agreement with the bidder that offers the highest price and



the most favorable contractual terms. The competitive tension generated by a well-run auction process permits a seller to maximize the price obtained and reduce its exposure by minimizing the number of warranties and indemnities given by the seller to the buyer in relation to the target business.

## Public companies

In relation to public companies, a buyout is typically undertaken either by way of:

- (a) a takeover offer; or
- (b) a scheme of arrangement.

Irrespective of whether the takeover is structured as an offer or scheme, compliance with the provisions of the Takeover Code is mandatory in both cases if the target is subject to the Takeover Code. Each option has advantages and disadvantages and the selected option depends on the circumstances of the transaction and the target. In certain circumstances, it is possible for the takeover structure to be switched from a scheme to an offer (or vice versa) during the course of the buyout.

### *Takeover offer*

A takeover offer is a formal proposal by the bidder to the shareholders of the target company to acquire their shares. It requires a minimum acceptance by over 50% of the voting share capital of the target company, although 90% acceptance is needed for the bidder to invoke the statutory compulsory acquisition procedure and acquire the remaining shares. The squeeze out of any minority shareholders is preferable if the target is to be de-listed and converted to a private company, which is generally required if it is to go through a whitewash procedure (please see the answer to question 17 below) and give security for the acquisition debt.

A takeover can either be recommended by the board of the target company (or its independent directors in the case of a management buyout), failing which it will be hostile. As a scheme of arrangement is a proposal put forward by a company to its shareholders, if the target board is not supportive of the transaction and refuses to recommend the takeover, it is not usual to propose a scheme.

### *Scheme of arrangement*

A scheme of arrangement, on the other hand, is a statutory procedure which requires the target company to conduct a court-approved reconstruction resulting in its ultimate acquisition by the bidder. It requires approval by target shareholders representing a majority in number and 75% or more in value (excluding any shares held by the bidder or its associates) of those attending (whether in person or by proxy) the relevant meeting, as well as the subsequent sanction of the court. Once approved by the required majority, the scheme binds all target shareholders.

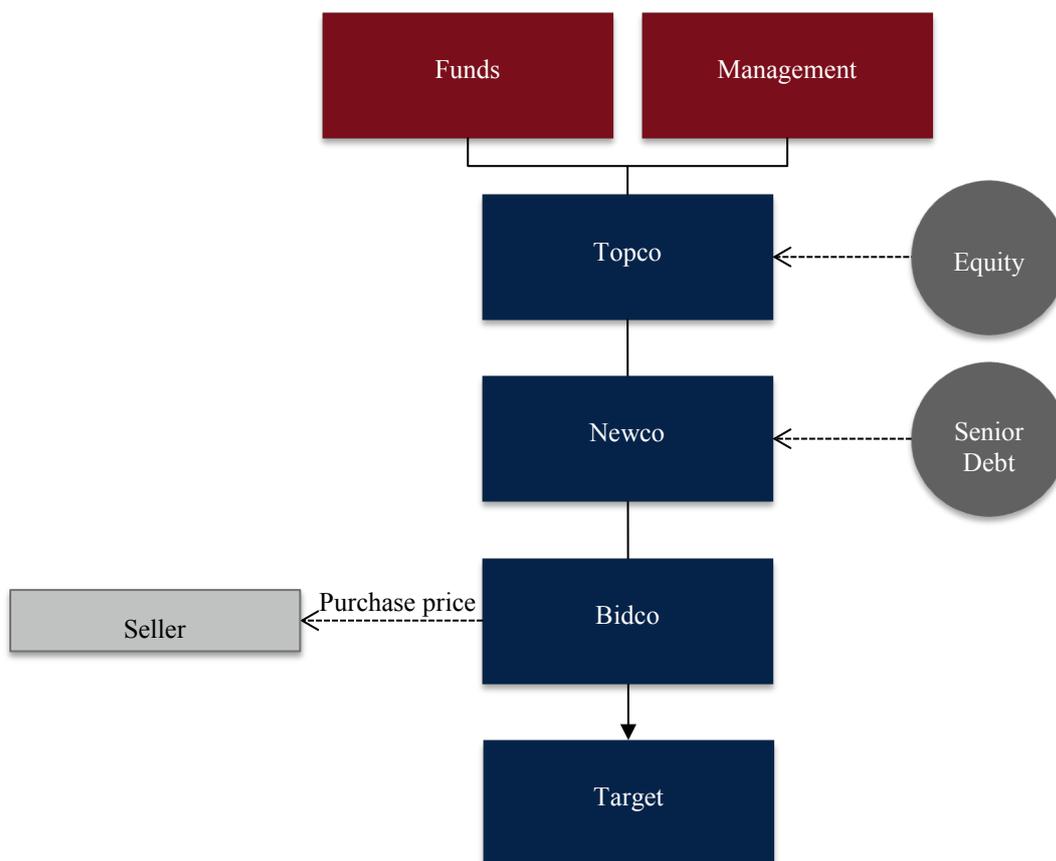
## 6. What is the typical corporate structure used when doing a buyout?

Funds typically undertake a buyout of a target company through three levels of newly incorporated companies as follows:

- (a) a top company which receives funding in the form of equity subscription from the fund or funds (if a number of funds participate together in a club or consortium deal to acquire the target) and from any managers invited to invest in the company (**Topco**). The funds, together with any funds with which they are co-investing, are always the majority shareholders in the company;
- (b) a company which receives debt funding from one or more different sources (**Newco**); and
- (c) a company which purchases the target (**Bidco**).

The purchase price for the target company and related expenses are generally satisfied through the sources of debt and equity funding.

A typical buyout structure illustrating the above would be:



Ultimately the choice of the corporate structure used when undertaking a buyout is driven by multiple factors, including:

- (a) the tax requirements of the funds and the managers (in particular, the jurisdiction of the newly incorporated companies depends largely on the requirements of the funds and managers);
- (b) the size of the deal (for instance, on smaller deals a simple buyout structure is often used with only one newly incorporated vehicle);
- (c) the requirements of the banks (on deals with multiple layers of debt, banks may require that the senior debt is lent to Bidco so that the junior debt is structurally subordinated to the senior debt).

## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

A number of documents are common to buyouts of public companies and private limited companies, particularly in relation to the structuring of the equity funding required for the buyout. However, the documentation needed for the acquisition of the target company differs significantly depending on whether the target company is a public company or a private limited company.



The key documentation common to both public and private company buyouts is as follows:

- (a) a confidentiality agreement between the target/seller and target/Bidco, which, in the case of a public company buyout, may include a standstill commitment from Bidco, prohibiting Bidco from acquiring shares in the target or making a non-recommended bid for the target;
- (b) a shareholders agreement governing the operation of Topco (or Newco/Bidco in more simple acquisition structures);
- (c) a subscription agreement governing the terms of the equity investment into Topco which may include warranties given by managers (please see the answer to question 8);
- (d) where the subscription agreement contains warranty protection given by the managers to the fund in relation to the target business, a disclosure letter containing any qualifications or exceptions to the warranties given;
- (e) the articles of association of Topco; and
- (f) employment agreements between the managers and Topco or the target company.

Other possible common documents which may be prepared include an employee share option plan as an incentive for those employees who are not taking a direct equity participation in Topco, and possibly a registration rights agreement, if a future listing on a U.S. investment exchange is viewed as a likely route for an eventual exit.

#### *Private company buyouts*

In a buyout of a private company the key documents also needed include the following:

- (a) sale and purchase agreement between the seller and Bidco, detailing the terms of the buyout and the allocation of risk and liability between the seller and Bidco;
- (b) where the seller gives any warranty protection to Bidco, a disclosure letter containing any qualifications or exceptions to the warranties given;
- (c) tax deed containing an indemnity given by the seller for all unpaid/unprovided tax liabilities of the target company; and
- (d) possibly, where the nature of the target company's business indicates that environmental liabilities are a material risk, a separate environmental deed under which the seller agrees to cover all, or an agreed percentage of, the liability of the target company for environmental contamination.

Prior to beginning detailed due diligence and negotiation of contractual terms, a bidder may also request a period of exclusivity, during which the seller would agree not to negotiate with, or sell to, another buyer. In an auction process where the target is an attractive asset, bidders would typically not be granted exclusivity. To persuade bidders to accept this position and commit resources, a seller needs to have done significant preparatory work and have anticipated the information and other needs of bidders. If one is to be granted, any period of exclusivity may be included within the confidentiality agreement or in a separate exclusivity agreement. Except in the case of auction processes, negotiation of the detailed terms of the buyout often begins with the circulation of a term sheet or memorandum of understanding setting out a summary of points agreed, or to be agreed, between the investor, and the seller.

#### *Public company buyouts*

The nature of the documentation depends on whether the takeover is structured by way of an offer or a scheme (refer to question 5).

The key document for an offer is the offer document that sets out the terms and conditions of the proposed buyout, certain information about the target and the bidder, and in the case of a recommended takeover, incorporates the recommendation from the independent directors of the target board. In the context of a scheme, the key document is a scheme circular which is sent to target shareholders. The scheme circular contains the scheme of arrangement submitted to the court, an explanation of the scheme, a recommendation of the scheme by the board, the conditions to the scheme, certain information about the target and the bidder and notice of meetings. Certain documents are also required for the sanction of the scheme by the court, including a claim form, witness statements and various court orders.

Deal protections for both schemes and offers, the main type of document available to parties as a form of deal protection is an irrevocable undertaking, which sets out a commitment from the directors and, preferably, one or more existing target shareholders, to accept the offer when made by the bidder.

Further, throughout the process of the buyout, a number of announcements are issued by the bidder (and/or the target, particularly in the case of a scheme of arrangement) under the Takeover Code. The Takeover Code contains detailed content requirements and the Panel should be consulted if there is uncertainty as to whether certain information should be included in the offer or scheme document and relevant announcements.

## Banking

### *Lending*

The main banking document is the facilities agreement under which the terms of the loan made to the Newco are documented.

### *Security*

If the transaction is secured, separate security documents are also required to provide the lender with security for the obligation to repay the loan. The nature of the security depends on the circumstances and can include fixed and floating charges, share pledges and other forms. If the target company (being a UK company) or its subsidiaries are required to guarantee the acquisition debt and to grant security over their assets in favor of the lender to secure the repayment obligation, financial assistance issues may arise (refer to the answer to question 17 below). In summary, restrictions apply to public companies giving financial assistance and subsidiaries of public companies giving financial assistance for the purpose of the acquisition of shares in a public holding company.

### *Subordination*

If there are different debt providers, their relative positions depend on the extent of any subordination and other contractual arrangements negotiated between the parties. Subordination may be implemented either by way of structural subordination (where the senior creditor lends to a company (usually one of the operating subsidiaries in which assets are held) which is lower in the group structure than the company to which the junior creditor lends) or contractual subordination (where loans are made to the same company but the senior creditor and junior creditor agree on the priority of payment by contract, typically in an intercreditor agreement which regulates the rights of the various funders and the relationship among all the various parties).

### *Certain funds*

A key factor to be mindful of in a public company buyout is the requirement for certain funds, so that at the time of the formal announcement of the buyout, full financing must be available on an unconditional basis (i.e., conditional only on the buyout completing). The banking documents must reflect this certainty of funding.



## 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

### Private company buyout

A fund would wish to undertake a detailed due diligence exercise in relation to the target to identify risks and liabilities and, where possible, to factor identified risks and liabilities into the purchase price.

#### *Warranties*

A fund would wish to have an extensive range of warranties from the sellers and management that are designed to verify the information provided, ensure that any potential issues in the business are disclosed, and make sure that the seller bears the risk of unknown liabilities in the target company. How successful the fund is in getting these warranties depends on the attractiveness of the asset (i.e., the level of competition) and the price being paid. The position ranges from a full set of warranties covering all aspects of the business at one end of the spectrum to warranties covering only title to the shares and capacity to sell at the other.

#### *Indemnities*

Where there are known but unquantified liabilities of the target company, a fund may also seek indemnities in relation to those risks to the extent that they are not factored into the purchase price. Quantified liabilities are typically dealt with as part of the price discussion.

#### *Purchase price adjustments and escrow*

As security for the payment of any claims under the warranties and indemnities, a fund may request that part of the purchase consideration be withheld or placed in escrow for a fixed period to meet any warranty or indemnity claims or that a third party guarantee for those claims is provided by a creditworthy entity.

Protection in the form of a purchase price adjustment based on completion accounts may also be sought. These typically support a cash-free debt-free purchase structure and adjust the consideration depending on whether the net assets or working capital is above or below an agreed target.

#### *Warranty & Indemnity insurance*

Increasingly, warranty and indemnity insurance is being used to cover breaches in warranties (and, in certain cases, indemnities) given by the seller. There are currently two main types of warranty & indemnity insurance available on the market: a buyer-side policy and a seller-side policy. Under a buyer-side policy, the buyer is insured for losses it suffers from a breach of a warranty given in the sale documentation. As the insurance premium is borne by the buyer, it needs to be factored into the purchase price. The buyer also generally seeks to have the cap on the seller's liability under the share purchase agreement mirror the retention under the policy to ensure that there is no gap in the coverage. Seller-side policies are less popular, as under these policies, the seller remains contractually liable in the first instance to a claim by the buyer for a breach of warranty.

#### *Conditions precedent*

On a private company buyout, it is also common for a fund to impose conditions precedent which must be fulfilled before the completion of the acquisition as a means for the seller to remedy problems identified through due diligence (e.g., absence of a license, material adverse change, etc.).

### Public company buyout

In a public company buyout, the fund does not obtain any contractual protection from the selling shareholders of the target company and, in that situation, it can only seek to obtain comfort from any

managers who are taking an equity participation in the vehicle bidding for the target. In this context, warranties are generally sought from management more to ensure the proper disclosure of information, than to provide a means of financial redress if the warranties prove to be untrue. Management tends to warrant the reasonableness of any business plan put forward, confirms certain factual information contained in due diligence reports and confirms that forecasts and projections were prepared in good faith.

The due diligence exercise tends to be more limited on a public buyout. The bidder is likely to be able to receive some protection against aborted due diligence and other deal costs, however, by negotiating for an inducement fee to be payable by the target in certain circumstances where the takeover is launched but does not complete (for example, because a competing bid prevails or the target board withdraws its recommendation).

On a buyout of a public company the Panel does not normally allow subjective conditions or pre-conditions other than in respect of regulatory or competition clearances. Further, a bidder may only invoke a condition, other than the acceptance condition if the takeover is conducted by way of an offer, or the shareholder or court approvals condition, if the takeover is conducted by way of a scheme of arrangement, with Panel consent.

Recent changes to the Takeover Code have restricted the documentation that can be entered into on a public buyout, therefore reducing the deal protection available to private equity bidders. Under the current rules, subject to certain exceptions in relation to auction processes and ‘white knights’, a target company cannot enter into any offer-related arrangement with a bidder. This prohibition covers, amongst other arrangements, any implementation agreements (although it is thought in relation to schemes of arrangement that limited co-operation agreements are possible), non-solicitation (or ‘no shop’) agreements and break fees payable by the target (except in limited circumstances). The Takeover Code does not include any specific provision in relation to:

- (a) ‘fiduciary outs’ or the possibility of the committee of independent directors withdrawing its recommendation (nonetheless, as the directors do owe fiduciary duties to their company, they may rely on these to withdraw a recommendation); or
- (b) ‘go shop’ periods. As discussed above, there is a prohibition in the Takeover Code on ‘non-solicitation’ or ‘no shop’ restrictions, and therefore there is nothing to stop the directors from soliciting a competing bid.

## 9. Do laws exist regulating how a management team’s conflicts of interest are managed in a typical management buyout?

### General and fiduciary duties

Management may be in a position of conflict due to the contractual obligations they owe to the target company under any service agreement (e.g., non-compete and confidentiality provisions). In the absence of any service agreement, an employee owes a common law duty of fidelity to the target company that may also be brought into question if the employee pursues a management buyout.

If a manager is a director of the target company as well as an employee, a number of additional conflicts also arise from the fiduciary duties associated with holding office.

### Managing conflicts of interest

There are no specific laws regulating how conflicts of interest should be managed in a typical management buyout and a well-advised employee or director wishing to pursue a management buyout should seek consent from the target company in relation to the management buyout. That consent is often given in the form of a management/transaction protocol letter that establishes a method for the conduct of the buyout.



Further, an independent committee of the board is often established to address issues arising from the buyout that affect the target company. In a public company buyout, target directors with a conflict of interest are prohibited from giving their views on the offer (i.e., participating in the target board recommendation). Directors are normally regarded as having a conflict of interest where it is intended that they would have a continuing role in the bidder or target company if the offer is successful.

The Takeover Code requires that an independent committee of the board is set up to consider and negotiate the buyout proposal. The Takeover Code also requires a target company to obtain competent independent advice (typically given by an investment bank and known as the Rule 3 adviser) on any offer and for the substance of that advice to be made known to target shareholders. The Takeover Code specifies that the independence of the adviser must be beyond question.

## 10. How are the equity arrangements typically regulated in a buyout?

The equity arrangements in a buyout are typically regulated by a shareholders agreement entered into by the Topco, the fund or funds providing the equity, the managers invited to invest in Topco and any existing shareholders who are retaining an interest in the target following the buyout. The articles of association of Topco are also amended to reflect the terms of operation of Topco, and the rights attaching to the shares in Topco.

In a public company buyout, additional issues arise if any of the investors (including management) in Topco have an interest in the target's shares. One of the six general principles of the Takeover Code is that all security holders in the same class must be afforded equivalent treatment. Therefore, if it is proposed that management roll over their target shares into Topco shares but other shareholders are offered cash, the Takeover Code provisions on special deals need to be complied with (please see the answer to question 15 below).

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

Generally, English law does not impose any restrictions on the classes of equity security that can be issued by an English company on a buyout. Shares with a variety of different rights may be created and so there is lots of flexibility to tailor rights among different stakeholders.

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

### Companies Act

The starting position is the Companies Act 2006 (**Companies Act**), which sets out statutory provisions in relation to the appointment and removal of directors. Generally, if there is no provision to the contrary in the articles of association, a simple majority of members may appoint and remove directors.

Again, if there is no provision to the contrary in the articles of association, each director has a single vote at board meetings and all decisions capable of being passed by the board may be passed by a simple majority of directors. The chairman is not entitled to a casting vote.

### Shareholders agreement and articles of association

English law allows shareholders significant freedom to structure the board and the voting rights as they please. On a buyout, governance is effected at the level of Topco. The statutory position is normally modified by provisions set out in a shareholders agreement and the articles of association. They describe the rights of the equity holders to appoint and remove directors, the quorum requirements for any board meeting and the voting rights of directors at board meetings. On

institutional buyouts with no management participation, the articles of Topco would generally be very simple and it would be unusual to have a shareholders agreement in place.

A key restriction to this freedom relates to the removal of directors. The company's articles of association cannot exclude the Companies Act provision that a director can be removed by a simple majority vote of the shareholders. To prevent certain shareholders from having the power to block or impose a removal of a director, a solution would be to give weighted voting rights to shareholders with director nomination rights.

### **13. What measures are commonly used to give a fund some level of control over key operating and financial decisions made by an investee company?**

The fund usually appoints directors to the top company (Topco) in the group and reserves (but does not exercise) the right to have representation on the board of the various operating companies. Representation on the board may also include presence on audit, compensation and other committees. From a risk management perspective, the fund does not generally appoint directors to operating entities.

As a fund is relying on the management team to run the business and does not have day-to-day control over operations, the shareholders agreement typically contains a number of veto rights in favor of the fund, listing those transactions and matters where the managers need to seek prior consent from the fund before proceeding to carry out any relevant action.

The fund would also require detailed financial and operating information in relation to the target company to be provided to it by the managers for the fund to closely monitor the performance of its investment. Funds would normally also have the right to appoint their own investigating accountant if the fund has concerns about the financial performance of the target company or any irregularities that appear to have arisen.

The banking documents would also contain negative covenants and information requirements.

### **14. What employment terms are generally imposed on management in a buyout?**

A fund typically wishes to offer incentives to key employees to maximize the value of the business but, at the same time, wishes to protect the business if a key employee departs or underperforms.

#### **Service/executive employment agreements**

The terms of employment are set out in an employment contract or service agreement and the rights and obligations attached to any shares held by a manager in Topco are usually set out in the shareholders agreement and/or the articles of association of Topco. The service agreement between Topco or the target company and managers contains a series of key terms for the protection of the business of the target as follows:

- (a) 'whole time and effort' clauses, requiring a manager to devote 100% of his or her time to running the target business;
- (b) non-compete and confidentiality provisions to prevent a manager from competing with the target business and soliciting its customers and key employees for a period of time after the end of the employment; and
- (c) gardening leave provisions allowing for a departing manager to be put on leave during his notice period (for example, where it is determined that it would be counter-productive for the



departing manager to remain involved in the target business during the notice period, or where the leave is considered beneficial for the protection of the business).

## Management shares

Additionally, if a key employee also holds equity in the company, he or she would be required to sell or transfer those shares (please see the answer to question 15 below).

A share option plan typically contains arrangements so that any voluntarily departing employee does not retain any options already awarded to him or her. It may contain more beneficial terms that apply if the employee is dismissed for certain reasons which are considered to be other than for 'cause'.

## Consents

In a public company buyout, the Panel may need to consent to the proposed new employment terms if members of the management team are also target shareholders. The Panel should be consulted as soon as practicable. It requires, as a condition to its consent, that the target's financial adviser (the Rule 3 adviser) states publicly (in the scheme/offer document) that, in its opinion, the arrangements with management are fair and reasonable.

## 15. What incentives can be offered to management and how are they typically structured?

### Sweet or 'sweat' equity

Generally, in addition to salary, benefits and bonuses, incentive plans for management are structured either through direct equity in the company (Topco) or through share option plans.

A common incentive structure to ensure that the management team's interests are aligned with those of the fund is to split the equity of Topco into:

- (a) preferred equity or loan notes with a fixed debt-like return; and
- (b) ordinary equity, often referred to as 'sweet equity'.

The sponsor subscribes for a mixture of the two classes but management receives only sweet equity (or a higher proportion of sweet equity). If the value of a common/ordinary share exceeds the face value and accrued coupon of the preferred equity, the sweet equity receives a greater return than the preferred shares. It is also sometimes referred to as 'sweat' equity, because, when seen in conjunction with leaver provisions, it is earned by the managers' hard work.

### Ratchet mechanism

Another common incentive employed is a ratchet mechanism by which the percentages of equity held by management and the fund alter, on an eventual exit, according to the management's performance and the exit proceeds realized by the fund. If management does well and the fund's exit proceeds exceed agreed target thresholds (typically both the internal rate of return and a money multiple), the amount of equity which management holds may be ratcheted upwards so that management earns a greater amount of the proceeds. It is also possible to provide that management has their shareholding ratcheted downwards if the eventual sale proceeds do not exceed agreed target thresholds. The type of ratchet mechanism adopted requires careful consideration of the tax implications to ensure the managers obtain favorable tax treatment. Typically, for tax reasons, a manager's equity participation in the UK is structured so that he or she starts with the maximum entitlement and is ratcheted down if the relevant performance targets (or investor return) are not achieved.

## Management incentivization

### *'Good leaver' and 'bad leaver' provisions*

Incentives are typically in place to encourage managers to stay involved until exit, as the fund does not want to be in day-to-day control of the business. If an employee leaves the target business, he or she is obliged to transfer his or her shares back to the company. The value at which the departing manager is obliged to transfer shares depends on:

- (a) the circumstances of his or her departure (i.e., whether the manager is a 'good leaver' or a 'bad leaver'); and
- (b) if vesting provisions apply (which is more common for U.S. than European sponsors), how long the manager has been employed by the company (generally, the shares will not be fully vested until after 3 to 5 years of employment).

A 'good leaver' is generally a manager who retires through death, ill health or (in some cases) is made redundant or terminated other than for cause. In those circumstances, the manager is typically entitled to receive fair market value for his or her shares. A 'bad leaver' is generally a manager who is not otherwise classified as a good leaver. A bad leaver is normally only entitled to receive the lower of the original acquisition cost and the market value for his or her shares. Actual payment for any shares transferred by a leaver may be delayed until exit so that there is no incentive to leave early. These provisions are usually set out in the shareholders agreement.

### *Public company buyout*

In a public company buyout, the Panel must consent to the proposed management incentive arrangements if management are also target shareholders. The Panel should be consulted as soon as practicable and will require as a condition to its consent that the target's financial adviser (the rule 3 adviser) states publicly in the scheme/offer document that, in its opinion, the arrangements with management are fair and reasonable. The Panel will also require that these arrangements are approved by target's shareholders in general meeting. Only independent shareholders may vote on the resolution and the vote must be taken on a poll.

### *Tax considerations*

Tax considerations form a crucial part of the structure of management incentivization schemes. Under current rules, UK tax resident management have to pay for their shares at market value to avoid a tax charge. For managers who are UK taxpayers, where possible, the management's equity participation should be structured so that any gains on a future sale of shares are taxed as capital gains and not as income. It may be possible to structure the management shareholding to enable the managers to benefit from 'Entrepreneurs' Relief', with the result that any capital gain they make on eventual sale of their shares is taxed at 10% rather than 28%. This is subject to certain conditions being satisfied in relation to the voting rights and proportion of nominal value represented by each manager's shares, the length of time each manager has held those shares, and an overall individual lifetime limit on the relief for each manager.

## 16. How are buyouts typically debt financed and secured?

### Typical financing

Buyouts are typically financed from two principal sources:

- (a) Equity from the fund (and, in some cases, the management team). The equity usually comprises a combination of share capital (equity) and subordinated shareholder loans provided by (or loan note instruments issued to) the fund; and



- (b) debt finance raised from financial institutions and other investors. The debt finance typically comprises:
- (i) senior debt (from banks, pension and insurance funds and hedge funds); and
  - (ii) junior debt which may consist of mezzanine debt, high yield debt and/or payment-in-kind debt which is only redeemed after all the senior and other junior debt has been repaid and is subordinated to all other forms of acquisition finance (PIK Debt).

The seller may also provide finance for a buyout that is often structured as vendor loan notes. The split between debt finance and equity is determined on a transaction-by-transaction basis.

#### *Senior debt*

Senior debt is the principal source of debt in buyouts and ranks in priority to junior debt and other subordinated debt. Senior debt typically includes acquisition finance by way of term loans (to complete the purchase of the target or the target assets) and revolving credit facilities (to meet the ongoing working capital needs of the target group).

#### *Mezzanine debt*

Mezzanine debt ranks behind the senior debt but ranks ahead of any shareholder loans provided by the shareholders or Newco, equity capital and vendor financing, if applicable. Mezzanine debt may be provided by a range of players including specialist mezzanine finance providers, the fund providing the equity, the seller (if it wishes to maintain an interest) or a senior debt provider (in addition to the senior debt). The mezzanine debt generally comprises a term loan which is subordinated in terms of priority of repayment and, if relevant, security behind the senior debt. Mezzanine debt may carry the additional benefit of warrants to subscribe for equity in the company at a future date although this is now only common in lower mid-market and smaller deals.

#### *High yield bonds*

In larger transactions, the mezzanine debt may be replaced (or a temporary mezzanine facility refinanced) by high yield bonds. Due to the mechanics for issuing high yield bonds, they are more usually used to refinance bank debt incurred to make the acquisition of the target (or the target's assets), rather than being used to fund the purchase price at completion. However, there is a growing trend for acquisitions to be financed directly by the proceeds of a high yield bond which are held in escrow, rather than using a bridge facility.

#### *Certain funds*

On a public company buyout the requirement for certain funds applies (please see the answer to question 7).

## **Security**

Security is likely to be required by both the senior lenders and the junior lenders over all (or substantially all) of the assets of Newco and the target group (subject to compliance with any applicable financial assistance provisions). Security is typically obtained through the usual mortgages and charges (fixed and floating).

Where there is senior and mezzanine debt, it is common to have a single common security trustee holding the security for all the senior and mezzanine lenders. The senior lender that arranged the senior debt is usually appointed as the security trustee and on enforcement of the security distributes the enforcement proceeds in accordance with the contractual ranking provisions in the intercreditor agreement. The alternative would be to have security in favor of the senior lenders (or a security trustee on behalf of a syndicate of senior lenders) and separate second ranking security in favor of the mezzanine lenders (or a security trustee on behalf of a syndicate of mezzanine lenders). Newco's

obligations under the financing documentation are typically guaranteed by members of the target group with those guarantees being supported by security over the guarantors' assets.

## 17. Are there financial assistance issues to consider when undertaking a buyout?

Under the Companies Act, a UK public company is prohibited from providing financial assistance (directly or indirectly) for the purposes of the acquisition of shares in that public company, unless certain exceptions apply. Financial assistance includes the provision of guarantees and security. The provision of financial assistance post-acquisition is also prohibited.

The prohibition operates directly and indirectly. As such, it is unlawful for a UK public subsidiary to give financial assistance for the purpose of an acquisition of shares in its private holding company. Similarly, a private company that is a subsidiary of a public company is prohibited from giving financial assistance for the acquisition of shares in its public holding company. Once again, the prohibition is subject to certain exceptions and extends to the subsidiary company giving any post-acquisition assistance.

However, there are no statutory restrictions on a private company providing financial assistance for the purposes of the acquisition of shares in it or another private company. There are also no statutory restrictions on the giving of financial assistance for the purposes of the acquisition of shares in a sister company.

There are both civil and criminal penalties for breach of the financial assistance provisions. These include the transaction being held to be void and unenforceable (including any security or guarantee given in contravention of the prohibition) and two years' imprisonment for officers involved in the breach.

## 18. What are the implications under the corporate benefit laws of England and Wales for a company providing financial assistance?

Under the Companies Act, the directors of a company must act in a way that they consider would promote the success of the company for the benefit of its members as a whole. If a company is providing financial assistance for the acquisition of its own shares, its directors must consider whether they are acting in accordance with their duties, particularly where the transaction may seem to be of little or no corporate benefit to the company.

In some circumstances, it will be relatively easy to demonstrate corporate benefit. This might be the case where a parent is providing guarantees and/or security in respect of the obligations of a wholly-owned subsidiary. However, it may be harder to demonstrate corporate benefit where, for example, a subsidiary is providing guarantees and/or security to its parent or to a sister company. In this scenario, it is usual to record the reasons for the provision of financial assistance in the board minutes and to ratify the transaction by way of a shareholders' resolution.

The directors of the company providing financial assistance should also, in the ordinary course, consider any capacity, maintenance of capital or insolvency issues and their general duties as directors under the Companies Act.

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

English insolvency laws are fairly complex in relation to priority of claims between different creditors, and, in particular, different secured creditors (e.g., holders of fixed charges and holders of floating charges). However, as a general rule, a secured creditor is in a better position than an unsecured creditor, and ordinarily has priority over an unsecured creditor. There are exceptions to this



rule, for example, where the security was created in circumstances where it may be challenged (e.g., if it constitutes a preference).

The remuneration and expenses of the insolvency practitioner are paid for before any distribution to secured or unsecured creditors.

Preferential creditors are paid after payments to fixed charge holders, but before floating charge and unsecured creditors, and are prescribed by statute to be the following:

- (a) contributions to occupational and state pension schemes;
- (b) employees (for work done in the four months before the insolvency date, up to a maximum of GBP 800 per person); and
- (c) holiday pay due to any employee whose contract has been terminated, whether that termination takes place before or after the insolvency date.

Note that HMRC removed its right to be a preferential creditor in 2002.

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

The tax consequences of the buyout for the fund depend on its exact structure. The fund needs to consider the tax implications at every stage of the buyout, such as:

- (a) the tax treatment of the equity subscribed for by any employee of the company;
- (b) the tax treatment of the interest charges arising on any acquisition finance, including whether those interest charges are deductible against profits of the business for tax purposes and whether any withholding tax applies on the payment of that interest. The rate of UK withholding tax is currently 20% (subject to exceptions under, for instance, double tax treaties);
- (c) the tax treatment of dividends. There is no UK withholding tax on dividends, and a broad exemption from corporation tax applies to dividends received by UK companies, although individuals are taxed on dividends received;
- (d) recovery of VAT on costs and expenses;
- (e) securing relief for losses;
- (f) minimizing any stamp duty or stamp duty reserve tax that arises on the transfer of any shares. The rate of stamp duty and stamp duty reserve tax is 0.5% of the share purchase price, regardless of the value of the shares themselves; and
- (g) ensuring any exit occurs on a tax efficient basis for the fund and management.

## 21. What forms of exit are available?

In solvent situations, the common forms of exit (which are often pursued in tandem to seek the most favorable result) are:

- (a) via initial public offering - where both the fund and the management are usually required to retain at least a portion of their shares and to agree to a lock-up for a period agreed with underwriters;
- (b) a trade sale to a corporate or other strategic investors - which typically provides a complete exit for the fund (if not management) but depends on the existence of a buyer with the resources and appetite to pay a good price and no regulatory constraints;

- (c) a sale to another private equity firm (a secondary buyout) - where the funds exit and the management normally rolls over (i.e., reinvests) at least a portion of their proceeds into the new company; and
- (d) a leveraged recapitalization by which following the recap, the target company is re-financed and the proceeds of the new finance raised are sufficient to enable the fund to replace the existing acquisition finance facilities used on the buyout and to return cash to the shareholders through the payment of dividends, a share buyback or a reduction of capital.

In insolvent situations if the company cannot be sold to a third party, there are various rescue schemes that are available to the company. These are:

- (a) administration, where the company may be reorganized, rescued or its assets realized by an administrator appointed to the company and with the benefit of a statutory moratorium;
- (b) company voluntary arrangement, where the company and creditors agree on a solution which is implemented by an insolvency practitioner; or
- (c) a scheme of arrangement, where the court sanctions a scheme of compromise between the creditors, members and company.

In certain circumstances, an administrative receivership may also be possible but this was effectively abolished by the Enterprise Act 2002, except for in limited circumstances.

If none of the above rescue solutions are possible, then liquidation may be the only other alternative available. There are two types of liquidation:

- (a) compulsory - by order of the court following petition from a creditor; or
- (b) voluntary -by resolution of the company either by the members passing a special resolution to wind up the company, if the directors are willing to give a statutory declaration of solvency, or where the directors are unwilling to make a declaration of solvency, by the members passing a special resolution that the company is unable to continue business by reason of its liabilities and should be wound up.



## United States

### 1. What structures do private equity funds typically use to manage their funds?

Private equity funds are typically formed as limited partnerships that provide investors with liability limited to their commitment to the fund. Historically, the limited partnership has been the vehicle of choice because it provides tax-transparency for U.S. investors as well as providing management control to the general partner (an entity formed, and controlled, by the sponsor).

In funds targeted to U.S. domestic investors only, a limited liability company structure is often used. In funds with U.S. tax-exempt investors or non-U.S. investors, a corporation, or a partnership that elects to be treated as a corporation for U.S. tax purposes, may be employed to hold the investments by the investors. While the general partner controls the fund, day-to-day management services are typically provided by a separate management company established by the fund sponsor. This separate management company employs the fund management personnel and provides administrative services to funds managed by the sponsor. The management company and the fund typically enter into a management agreement setting out the duties and compensation payable for these services.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in the United States of America?

#### Private equity fund

Generally, a private equity fund in the U.S. does not need to be licensed to conduct business, other than receiving basic business licenses from the states or municipalities in which the fund conducts business. Private equity funds typically qualify for an exemption from registration as investment companies under the Investment Company Act of 1940 (**Investment Company Act**).

#### Private equity fund manager

A private equity fund manager is required to register as an investment advisor under the Investment Advisers Act of 1940 (**Advisers Act**) unless the manager qualifies for an exemption from the registration. Until recently, relief from registration was granted under the Advisers Act to certain classes of investment advisers who had had fewer than 15 clients in the prior 12 months. However, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 eliminated the exemption based on a limited number of clients and moved instead to the asset-based test described below.

#### *Private Fund Adviser Exemption*

Private equity fund managers with assets under management in the U.S. of less than USD 150 million and who exclusively advise private funds are exempt from registration (**Private Fund Adviser Exemption**).

‘Private funds’ include hedge funds, private equity funds and pooled investment vehicles excluded from the definition of ‘investment company’ under Sections 3(c)(1) or 3(c)(7) of the Investment Company Act. U.S. based private fund advisors must count all assets under management worldwide while foreign private fund advisors need only count the assets in funds managed from a place of business in the U.S.

An advisor relying on the Private Fund Adviser Exemption must still file certain portions of the Form ADV with the U.S. Securities and Exchange Commission (**SEC**) on an annual basis. The limit on assets under management must be reviewed annually at the time of the filing of the private equity fund manager’s Form ADV. Increases in the value of fund assets can cause the fund manager to exceed the limit.

It is possible that a private equity fund manager with assets under management in the U.S. of less than USD 150 million assets under management may be required to register as an investment advisor under state investment advisory laws.

#### *Venture capital fund adviser exemption*

A fund manager who manages venture capital funds is exempt from registration as an investment adviser. The SEC defines a ‘venture capital fund’ as a private fund that:

- (a) holds no more than 20% of the fund’s capital commitments in non-qualifying investments (other than short-term holdings);
- (b) does not borrow or otherwise incur leverage, other than limited short-term borrowing (excluding certain guarantees of qualifying portfolio company obligations by the fund);
- (c) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances;
- (d) represents itself as pursuing a venture capital strategy to its investors and prospective investors; and
- (e) is not registered under the Investment Company Act and has not elected to be treated as a business development company.

‘Qualifying investments’ are investments in the equity securities of private operating companies where:

- (a) the fund does not incur leverage in connection with its investment and distribute the proceeds of such leverage; and
- (b) the target is not itself a fund.

#### *Foreign Private Adviser Exemption*

A non-U.S. private equity fund manager may rely on the ‘Foreign Private Adviser Exemption’ if it:

- (a) has no place of business in the U.S.;
- (b) has fewer than 15 clients and investors in private funds advised by the manager located in the U.S.;
- (c) has less than USD 25 million in aggregate assets under management that are attributable to clients and investors in private funds advised by the manager; and
- (d) neither holds itself out generally to the public in the U. S. as an investment adviser nor acts as an investment adviser to any registered investment company or business development company.

A fund manager who qualifies for the Foreign Private Adviser Exemption does not need to file a Form ADV with the SEC.

#### *Small Business Investment Companies*

Smaller private equity funds often obtain funding and are licensed by the Small Business Administration (**SBA**) as Small Business Investment Companies (commonly referred to as **SBICs**), allowing those funds to supplement funding from private investors with funds from the SBA. Similarly, Minority Enterprise Small Business Investment Companies (**MESBICs**) are government-chartered private equity funds that may invest only in companies that are at least 51% owned by members of a minority group or persons recognized by the rules that govern MESBICs to be economically disadvantaged.



### 3. Are there any approvals required for investments by foreigners in the United States of America and, if so, what is the process?

Foreign investment in the U.S. is generally permitted without government approval. However, certain investments may require an ‘Exon-Florio filing’ with the US Department of Commerce. The Exon-Florio provision allows the President to review and block foreign investment in the U.S. if the investment would harm U.S. national security. The Exon-Florio Provision does not provide a specific definition of national security, but generally involves defense and high technology industries.

Under the Exon-Florio Provision, the Committee on Foreign Investment in the United States (**CFIUS**) has the responsibility of reviewing transactions and making a recommendation to the President. CFIUS has up to three years to review a transaction after it closes. However, if a party is concerned that a transaction may involve U.S. national security, it may make a voluntary filing after which CFIUS has 30 calendar days in which to review the transaction and decide whether it gives rise to national security concerns sufficient to warrant the initiation of a formal investigation. If CFIUS declines to initiate an investigation, the matter is considered closed and CFIUS may not subsequently reopen the case. If CFIUS determines that an investigation is warranted, an investigation must occur within 45 calendar days from that determination, during which the parties may attend a meeting with CFIUS to clarify any issues relating to the transaction. At the end of the 45-day period, CFIUS must present a report to the President, who is required to announce a final decision to Congress within a further 15 calendar days. As noted above, the President may decide to prohibit the transaction.

Also, any foreign investment in the U.S. requires an ‘information filing’ with the U.S. Department of Commerce on Form BE-13. This form must be filed within 45 days following the completion of the transaction and is used by the Commerce Department solely for internal data collection purposes.

### 4. Who are the relevant regulators in the United States of America and how much interaction would one generally expect when undertaking a buyout?

The primary regulatory authorities in the U.S. in a corporate context are:

- (a) US Securities and Exchange Commission (**SEC**) – the primary regulator of securities laws;
- (b) State securities commissioners and administrators (in particular New York and California);
- (c) Self-regulatory bodies such as the Financial Industry Regulatory Authority (**FINRA**), the New York Stock Exchange and the Nasdaq Stock Exchange which are the major stock exchanges in the United States, each of which provides additional regulations for entities listed on their exchange;
- (d) US Federal Trade Commission (**FTC**) in conjunction with the US Department of Justice (**DOJ**) – the competition/antitrust regulators; and
- (e) Other regulatory authorities particular to specific industries, such as the Federal Communications Commission (**FCC**), the US Food and Drug Administration (**FDA**) or Federal Transportation Commission.

Transactions with specific value thresholds also require the preparation and submission of a Hart-Scott-Rodino merger notification (**HSR Filing**) with the FTC by each party to the transaction. A 30-day waiting period follows from the date that all parties have submitted their HSR Filing during which time the FTC may make a second request for additional information regarding the transaction or approve the transaction. An early termination of the waiting period can be obtained where the transaction poses few anti-competitive concerns.

The level of expected involvement with the SEC, state securities administrators and the relevant exchange in a buyout situation largely depends on whether the transaction involves a public company. Private transactions do not generally involve the SEC or a state securities commission.

Interaction with other regulators such as the FCC largely depends on the nature of the transaction (e.g., does the acquisition involve a change of control over broadcast or other wireless frequency licenses?) and the parties concerned.

## 5. How are buyouts typically undertaken in the private and the public markets?

### Private context

In a private context, transactions are usually undertaken by way of a privately negotiated acquisition that is typically structured as either a stock or an asset sale. The terms of the agreement are typically set out in a detailed purchase agreement with thorough representations and warranties, and seller indemnification provisions.

### Public context

In the public context, buyouts are generally concluded either by way of a negotiated or unsolicited tender offer to the shareholders for their shares, or by way of a negotiated merger with the company's board of directors. In transactions undertaken via a tender offer, the bidder prepares a tender offer statement, which is filed with the SEC, setting out the terms of the offer, information regarding the target and bidder and certain other regulatory mandated information. Tender offers are subject to the 'best price rule' that requires the bidder to provide the same consideration to all holders of securities of the same class. If the transaction is undertaken as a merger, the bidder and target prepares and files with the SEC a joint proxy statement for dissemination to the shareholders in connection with the seeking of shareholder consent to the transaction.

In addition to the public reporting and disclosure requirements under the tender offer and proxy rules, bidders in the public company context must be mindful of their obligations under:

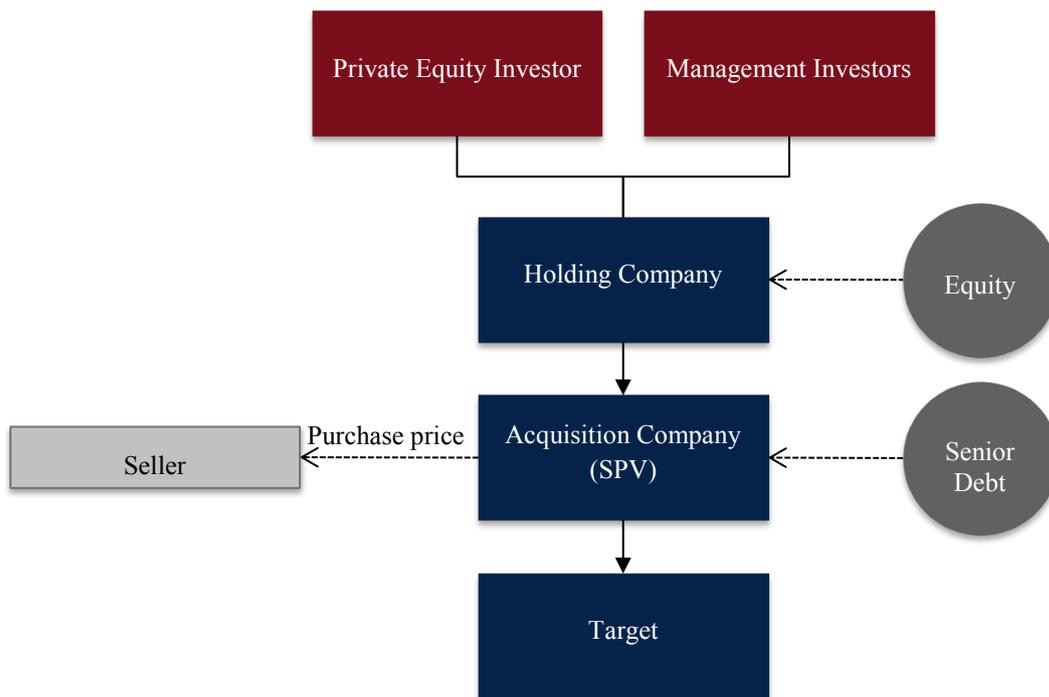
- (a) Section 16 of the Exchange Act relating to reports and purchases and sales of securities by affiliates;
- (b) Regulation 13d relating to reports by holders of 5% or more of the stock of a reporting company; and
- (c) the going private rules, which regulate tender offers by affiliates of an issuer.

Private equity bidders typically avoid bringing target management into the discussions in relation to a takeover prior to completion of the bid in order to avoid being deemed an affiliate of the target subject to the disclosure of sensitive value information, including all third party reports, opinions and appraisals materially related to the transaction.



## 6. What is the typical corporate structure used when doing a buyout?

Although acquisition structures vary from transaction to transaction, it is fairly common to see a two-level holding company structure adopted along the following lines:



The above structure allows the debt finance to be provided to the Acquisition Company SPV, and the equity contribution from the private equity fund or funds to be contributed at the Holding Company SPV level. The equity contribution is subsequently contributed down to the Acquisition Company SPV in the form of unsecured loan funds or equity, structurally subordinating the equity.

An alternative frequently-used structure would require the mezzanine debt to be provided at the holding company level, structurally subordinating the mezzanine debt as well as the equity to the senior debt. In more simple transactions the debt is provided directly into the target at closing, or into the acquiring company with the target merged into the acquisition company.

More elaborate structures invariably exist on larger more complex deals, particularly multi-jurisdictional transactions that often employ debt or hybrid securities to push down debt into the structure, creating the ability to lower subsidiary income and repatriate earnings as interest.

The acquisition entities may be corporations or limited liability companies. Limited liability companies that are accorded 'pass-through tax treatment' may be used to provide U.S. based managers with tax advantaged equity incentives.

## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Acquisition

For a buyout negotiated in a private context, the primary legal document that records the transaction is the stock or asset purchase agreement. There may also be other ancillary transaction documents prepared depending on the nature of the deal.

These can include:

- (a) employment agreements;
- (b) stockholders' agreement;
- (c) tax indemnification agreement; and
- (d) transition/shared services agreement.

For a buyout in a public context the documentation generally includes a merger agreement or stock purchase agreement executed with the target company, as well as various securities filings necessary to solicit proxies from, or submit a tender offer to, the stockholders including:

- (a) proxy statement;
- (b) tender offer statement;
- (c) Form 13e (going private filing);
- (d) Form 13d – statement of over 5% shareholder; and,
- (e) voting agreement (with major stockholders).

Public company acquisition agreements typically contain a 'fiduciary out' provision that allows the target board to terminate the purchase agreement if they receive a superior offer to that provided by the bidder, as well as a break fee of 3-4% of the purchase price payable to the bidder if the transaction is terminated. Private equity backed 'going private' transactions typically include a reverse break fee in the range of 6 to 7% of the purchase price payable to the target. With heightened shareholder scrutiny of board decisions in the M&A context, many public company acquisition agreements contain not only a 'fiduciary out' provision but also a 'go shop' provision that provides a period of time during which the target actively seeks other bidders to top the buyer's bid.

## Finance

The main banking document is the senior facility agreement under which the senior debt facilities (typically amortizing and non-amortizing term loans with working capital lines and, in some instances, capital expenditure or acquisition facilities) are documented. As well as the facilities agreement, the senior loan documents include promissory notes and security documentation including a security agreement, real property mortgages, assignment of rents and leases, uniform commercial code financing statements, securities pledge agreements and account control agreements. Perfection in collateral is typically obtained through the execution of a security agreement and filing of financing statements in relation to personal property and filing of a mortgage on real property.

Second lien financing is typically documented as a separate facility under the same facilities agreement as the senior loan facility.

Mezzanine debt is typically documented under a separate facility agreement under which the mezzanine debt is made available. There is also an inter-creditor or subordination agreement defining the respective rights of the senior and subordinated/mezzanine lenders.

## 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

### Private company

In a private company context, buyer protections usually take two forms. Firstly, there are pre-closing covenants, representations and warranties, walk-rights and break-up fees. Secondly, the seller (being



either the shareholder in a share sale or the company from which the business and assets are being acquired) provides post closing indemnity coverage. The terms of the indemnification coverage vary from transaction to transaction although it is quite normal to expect that limits be placed around any coverage, including claim thresholds and caps, time limits and adjustments for items otherwise disclosed.

Where the seller is a financial sponsor or a group of individual shareholders, it is quite typical that the bidder places a portion of the sale proceeds in escrow for a period. More recently, as auction processes have become more sophisticated, representations & warranty insurance has become prevalent. Representations & warranty insurance may be arranged by the seller as part of the auction process or may be arranged by bidders seeking to differentiate their bid from other bidders.

### Public company

In a public company context, the level of buyer protection which can be obtained is less than in a private context. The primary form of protection usually takes the form of conditions precedent to the acquisition (that either need to be satisfied or not triggered) and buyer break fees if the transaction does not close. Warranty protection from target shareholders is very limited and generally only extends to confirmation regarding unencumbered title and due authority to sell.

## 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

The corporate law of each state in the U.S. imposes certain general obligations on directors and officers of a corporation to act in accordance with their duties of care and loyalty. The duty of loyalty is tested in the management buyout setting because of the potential conflict between the personal interest of the management directors in favoring a transaction in which they will have an ongoing stake in the company and another transaction that may yield a higher return for shareholders.

Typically, particularly where the target is a public company, the target establishes a special committee of the board comprised of directors who are not a part of management or affiliated with the bidder to negotiate the terms of the transaction with the bidder. The target, particularly if it is owned by a financial sponsor or is a division of a larger company, may exclude management from the negotiations. Also, if the target is a public company, the inclusion of management in the bid team causes the transaction to be subject to the 'going private' rules, requiring significant disclosure regarding the information received, and procedures employed, to ensure that the price to the target shareholders is fair.

## 10. How are equity arrangements typically regulated in a buyout?

The equity arrangements in a typical buyout are regulated primarily by:

- (a) the certificate of incorporation or limited liability company operating agreement that sets out the terms of the various classes of stock; and
- (b) a shareholders agreement setting out rights such as rights of first refusal, co-sale rights, drag-along rights, and special voting or board representation rights.

Members of management also often enter into a separate restricted stock agreement placing vesting restrictions on their equity, setting up 'good leaver' and 'bad leaver' repurchase provisions and limiting the transferability of the shares held by management.

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

There is a great deal of flexibility under corporate law in the U.S. in relation to the types of equity security that can be issued and the level of 'rights tailoring' that can occur. It is common to see different classes of security issued to management and the private equity fund in a buyout.

In the capital structure of the acquisition company, the buyout fund typically invests in preferred stock or a combination of preferred stock and common stock. The management team invests in the same strip of preferred and common stock and receives a restricted stock grant of common stock to provide managers with an enhanced return on a profitable exit.

If a limited liability company is used as the holding company for the acquisition, the structure of the rights are typically tailored similarly to the structure in a buyout with a corporate acquisition vehicle, with the equity incentive grant structured as a 'profits interest' in the limited liability holding company. This grants its holders the right to participate only in the increase in the value of the limited liability holding company from the date the holder receives the interest in that company. This structure gives U.S.-based managers the ability to obtain capital gains tax treatment in relation to their interests.

Where the management team is located wholly in the U.S., profits interests are the preferred method of structuring the management incentive. Where management teams are located in multiple jurisdictions, the management equity is more typically structured as a combination of preferred and common equity with a weighting towards common equity for the management team.

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

### Board constituency

The relevant rules depend on the state of incorporation of the corporation. Many U.S. corporations that choose not to incorporate in the state where their headquarters are located incorporate in Delaware, because Delaware's corporation law grants management a great deal of flexibility in managing the corporation.

Most states, including Delaware, provide that a board of directors must consist of one or more individuals. An entity may not serve as a director of a corporation. State corporate laws also typically prohibit the granting of director proxies. Only the appointed director may count toward a quorum or vote on matters put before the board. Some states require a corporation to have at least three directors unless the corporation has fewer than three shareholders. Typically each director has one vote on matters put to a vote of the directors. Under Delaware law, however, the certificate of incorporation may provide differential voting rights to one or more directors. It is also typical for a board to create a committee or committees of the board. A committee may take actions without further ratification by the board, and in some states, such as Delaware, committees may also appoint sub-committees (e.g., a compensation committee may appoint a stock option grant sub-committee).

Corporations may also classify or stagger their directors' terms. If a vacancy occurs on the board, either the shareholders or the remaining directors can usually fill it. The bylaws may provide for the exact method of filling vacancies. There is generally no requirement that directors of a U.S. corporation are resident in the state of incorporation.

Generally, issues regarding board constituency, differential director voting rights and the removal of directors are all governed in the relevant shareholders agreement, or in the charter or bylaws of the corporation. It is common for private equity funds to have specific appointment and removal rights in



relation to a certain number of directors for their portfolio companies and for their voting rights to be aggregated where a director is absent from a meeting.

### Limited liability companies

If a limited liability company is used as the holding company, a more flexible governance structure may be employed. Limited liability companies may have a board of managers, a single manager, an entity manager or managers, allow for manager proxies, split management authority and responsibilities amongst multiple managers - whatever is agreed to by the members in the operating agreement of the limited liability company.

### Pension plan trustees

Private equity funds with U.S. non-governmental pension plan investors may require management rights to qualify as a 'Venture Capital Operating Company' under the US Employee Retirement Income Security Act (ERISA) rules regulating the fiduciary duties of pension plan trustees. To satisfy the obligation to obtain management rights, the Acquisition Company SPV typically enters into a separate management rights agreement with the fund, providing the fund manager with the right to receive reports and consult with management regarding the operation of the target business.

## 13. What measures are commonly used to give a private equity fund some level of control over key operating and financial decisions made by a portfolio company?

Typically, the preferred stock terms set out in the portfolio company's charter allows the holders of the class of preferred stock to separately vote to elect a majority of the directors of the portfolio company. The preferred stockholders, as a separate class, also have separate veto rights over certain portfolio company actions including:

- (a) mergers;
- (b) acquisitions,
- (c) a sale of assets,
- (d) the creation of preferred stock with an equal or senior preference,
- (e) amending the terms of the preferred stock; and
- (f) other actions that would affect the economic and voting rights of the preferred stockholders.

These rights are enshrined in either the charter/bylaws of the portfolio company or a shareholders agreement. They are granted directly to the shareholder (rather than being approved by the board of directors) to allow the shareholder to vote in its own interest, and are not subject to the fiduciary duties to act on behalf of all shareholders owed by the directors. The shareholders agreement may also contain specific reporting requirements or more specific veto rights.

The holders of the preferred stock typically have:

- (a) a pre-emptive right to acquire additional equity securities proposed to be offered by the portfolio company;
- (b) drag-along rights to force the sale of a minority interest if the financial investors want to create a liquidity event; and
- (c) rights of first refusal in relation to share transfers.

## 14. What employment terms are generally imposed on management in a buyout?

It is common for senior members of a management team in a buyout to enter into an executive employment agreement. Generally speaking, those agreements do not provide any fixed employment period, but include provisions for the payment of severance on termination of the executive's employment. The amount of severance is a matter of negotiation. It generally varies depending on the seniority of the relevant manager and may include benefits coverage as well as salary. Severance is typically payable on the termination of the employment of the manager by the portfolio company without cause (a 'good leaver' clause).

The employment agreement is likely to include a 'non-compete' covenant that runs for a period, typically a year, from the date of termination of employment. It prevents the departing manager from competing with the portfolio company's business or from soliciting its customers during that time. However, in certain states, particularly California, employment based 'non-compete' covenants (which are different to 'non-compete' covenants entered into in connection with the sale of a business) are not enforceable.

It is also common for compensation under executive employment agreements to include a fixed component and a bonus component referable to performance targets set by the board. The typical private equity management incentive structure also often involves a requirement that the members of the management team invest their own cash into the transaction. While the grant of restricted stock or stock options provides the management team with a strong incentive to produce positive returns, a requirement for management to invest their own cash prevents the management team from recklessly pursuing returns over the preservation of capital.

## 15. What equity incentives can be offered to management and how are they typically structured?

Incentives offered to management generally take the form of restricted stock, stock options, or profits interests. Phantom equity plans, which are intended to provide the economic equivalent of equity ownership, are more difficult to structure due to the negative U.S. tax treatment of deferred compensation. As such, phantom equity plans are typically only used with non-U.S. managers in certain jurisdictions where stock grants, options or profits interests have negative tax consequences for the manager or portfolio company.

### Restricted stock

Restricted stock generally refers to shares in the acquired entity (following the buyout) being subject to a vesting requirement that is either time-based or performance-based. It is not uncommon to use a combination of time and performance criteria for vesting. There is a great deal of flexibility in establishing the performance conditions that the management must achieve prior to vesting of the shares. The most typical condition is the passage of time. For example, if there were restrictions on 1,000 shares of restricted common stock held by a member of the management team, the restrictions typically lapse in relation to 250 shares per year over four years so long as the manager remains in his or her position with the portfolio company during that four year period. Other less common vesting conditions may include the portfolio company attaining certain performance targets, such as a minimum EBITDA level in a particular year or over some specified period. Prior to the lapsing of the restrictions, the portfolio company has the right to repurchase the shares for the price paid for them by the member of the management team. Additionally, the terms generally provide that vesting will be accelerated on the occurrence of certain pre-determined liquidity events for the sponsor (e.g., IPO, change-in-control).



From a tax point of view, it is preferable to have the restricted stock taxable to management on the grant date so that any subsequent appreciation in the shares can be taxed as a capital gain. This can be accomplished by making a timely election under Section 83(b) of the United States Internal Revenue Code of 1986, as amended (**Internal Revenue Code**) within 30 days of the grant date, or by structuring the restricted stock as a purchase by the management at fair market value. Bonus payments and loans can be used to fund this purchase, though the loans to certain executives would need to be repaid prior to an IPO filing, bear an interest rate specified by the U.S. tax authorities, and be at least partially recourse to the executive to ensure the appropriate tax treatment.

## Stock options

U.S. law provides for both tax-qualified (Incentive Stock Options) (**ISOs**) and non-tax qualified stock options (**Non-qualified Stock Options**). ISOs have the benefit of not triggering a tax liability for the recipient on grant or exercise of the option, allowing the recipient to obtain capital gains treatment on the increased value of the stock at the time of the sale. In many cases, however, Non-qualified Stock Options are used because the requirements for ISOs can be difficult to achieve in a buyout context and the value of the Nonqualified Stock Options is deductible to the granting corporation.

Options are generally subject to vesting conditions. Holders of Non-qualified Stock Options are not taxed until the exercise of the stock option, although the taxable amount is considered ordinary compensation income and subject to income tax at the holder's marginal tax rates.

## 'Profits interest'

Where a limited liability company issues the equity incentive, management may receive a 'profits interest'. As stated in the answer to question 11, this is a membership interest in the limited liability company that allows the holder to receive distributions only in relation to the profits or increased value of the portfolio company after the date of the grant. A profits interest is similar to an option in that it generally only benefits if there is an increase in the value of the limited liability company.

There is a great deal of flexibility in structuring profits interests (which are effectively created under the limited liability company operating agreement). It can be structured so that the profits interests only have value on a liquidity event and after the sponsor has recouped the original investment. Return on the investment can be split between the sponsor and management using a predetermined ratio or ratios (e.g., 90/10 or 90/10 on the first USD 50 million and then 80/20 on the next USD 50 million, etc.). Finally, the profits interest is preferable from the management's income tax perspective because the holder of the profits interest can realize capital gain tax treatment on his or her allocated return.

## 16. How are buyouts typically debt financed and secured?

While it varies from transaction to transaction, typically 50%-75% of the cost of an acquisition is provided from debt provided by banks and financial institutions. The amount of debt that can be raised is typically calculated as a multiple of the earnings of the target business. A leveraged buyout may employ all or a combination of the following debt and equity financing:

- (a) secured or unsecured high-yield bonds;
- (b) senior secured debt;
- (c) second lien debt;
- (d) mezzanine debt; and
- (e) vendor financing.

Acquisition finance facilities typically contain fewer conditions for closing than traditional bank facilities although conditionality is typically greater than in the European ‘certain funds’ context. ‘Covenant-lite’ loan agreements are returning to the market after a tightening of covenants in the aftermath of the global financial crisis.

Lenders often expect the equity to be structurally subordinated to the debt with the debt being lent to a special purpose finance company that is a wholly owned subsidiary of the holding company. Sometimes the senior lenders also require the mezzanine debt to be structurally subordinated. Typically however the lenders under the mezzanine debt, second lien debt and senior debt are a party to an intercreditor agreement providing for only contractual subordination.

Senior secured loans are typically secured with a blanket lien over substantially all of the assets of the target and its subsidiaries. Subsidiaries are required to guarantee the facilities. Perfection in personal property is typically achieved by the use of a security agreement and filing of a Uniform Commercial Code financing statement in the state of incorporation of the borrower. Certain types of assets, including real property, securities, bank and brokerage accounts, registered patents, registered trademarks, registered copyrights, motor vehicles, maritime vessels and aircraft are subject to alternative perfection regimes. Real property mortgages are typically subject to municipal, county and occasionally, state stamp taxes.

## 17. Are there financial assistance issues to consider when undertaking a buyout?

There is no prohibition on a company incorporated in the U.S. providing financial assistance in connection with the acquisition of shares in itself or its parent company, unless the company or its parent company is:

- (a) a natural person, corporation, partnership, trust, limited liability company, association, governmental authority or unit, or any other entity, whether acting in an individual, fiduciary or other capacity (**Person**) designated by the U.S. government on the list of the Specially Designated Nationals and Blocked Persons (**SDN List**) with which a U.S. Person cannot deal or otherwise engage in business transactions;
- (b) a Person who is otherwise the target of U.S. economic sanctions laws so that a U.S. Person cannot deal or otherwise engage in business transactions with that Person;
- (c) controlled by (including because that person is a director or owns voting shares or interests), or acts, directly or indirectly, for or on behalf of, any person or entity on the SDN List or a foreign government that is the target of U.S. economic sanctions prohibitions so that the entry into, or performance under, the relevant agreement would be prohibited under U.S. law; or
- (d) an ‘investment company’ or a company ‘controlled’ by an ‘investment company’ or a subsidiary of an ‘investment company’ within the meaning of the Investment Company Act of 1940.

## 18. What are the implications under the corporate benefit laws of United States for a company providing financial assistance?

There are three fundamental issues to be considered in relation to a company providing financial assistance as follows:

- (a) whether the company providing the financial assistance and the company that is the target or borrower are organized under the laws of the U. S., one of the fifty states, or the District of Columbia;
- (b) the corporate or limited liability company laws of the relevant state; and



- (c) fraudulent transfer provisions under state law and the federal bankruptcy statutes.

### Jurisdiction of organization

The jurisdiction of organization of the company providing financial assistance could trigger certain U.S. federal income tax issues.

Specifically, if a U.S. parent company (organized under the laws of the United States, one of the fifty states or the District of Columbia) seeks credit support from a subsidiary organized in a foreign jurisdiction that is treated as a 'controlled foreign corporation' for U.S. federal income tax purposes, Section 956 of the Internal Revenue Code could be triggered. If so, the accumulated 'earnings and profits' of the foreign subsidiary will be deemed to have been distributed to the U.S. parent and subject to corporate income tax (the maximum U.S. corporate income tax rate under current law is 35%).

For the purposes of Section 956 of the Internal Revenue Code, 'credit support' includes:

- (a) guarantees by the foreign subsidiary;
- (b) pledges to a lender over the shares of the foreign subsidiary representing two-thirds or more of the voting power of the foreign subsidiary; and
- (c) security interests granted to a lender by the foreign subsidiary over its assets.

As long as the credit support by the foreign subsidiary remains in place, there is a risk that all future earnings and profits of the foreign subsidiary will be deemed distributed to the U.S. parent and subject to U.S. tax as described above.

### State corporate and limited liability laws

As statutes vary from state to state and in the District of Columbia, the statute of the relevant jurisdiction must be reviewed in the context of the transaction.

Most corporate and limited liability law statutes, however, permit the granting of guarantees, unless the certificate of incorporation or bylaws or certificate of formation and operating agreement, as applicable, otherwise prohibit the guarantee.

Most states require the granting of the guarantee or other financial assistance to serve a corporate purpose. Many states, such as Delaware, presume corporate guarantees granted within affiliate relationships are necessary or convenient for the conduct of the guarantor's business. However, other states, such as New York, have no such presumption and courts have held that it is appropriate to examine the relationship between the entities, the reasons behind the guarantee and whether the guarantor expects 'beneficial results' from the transaction. In most states, such as Delaware, the courts generally view a corporate purpose liberally.

The relevant decision is generally made by the board of directors or managers, as applicable.. The test applied in relation to a decision (in most situations) is whether the board made the determination in 'good faith' and using 'reasonable business judgment.'

### Fraudulent transfer provisions

Fraudulent conveyance concerns arise under either:

- (a) the relevant state or District of Columbia statute (the Uniform Fraudulent Conveyance Act or the Uniform Fraudulent Transfer Act); or
- (b) Title 11 of the United States Code (**Bankruptcy Code**).

Any transfer occurring within one year of the bankruptcy of the guarantor may be set aside under the Bankruptcy Code, if the guarantor:

- (a) received less than ‘reasonably equivalent value’ in relation to the transaction **and** was insolvent or became insolvent by the transfer;
- (b) was undercapitalized, or rendered undercapitalized by the transfer: or
- (c) was unable, or rendered unable by the transfer, to pay its debts when they matured.

The most common insolvency test is on a balance sheet basis and assesses if liabilities are in excess of assets at fair market value.

The statute of limitations under state statutes is longer than the one year statute of limitations under the Bankruptcy Code. Most states, including Delaware, have a four-year statute of limitations period after the transfer.

In the case of a parent guarantee of subsidiary debt (a downstream guarantee), the parent is generally viewed as having received reasonably equivalent value because it owns the subsidiary. When a guarantee is given by a subsidiary to the parent (an upstream guarantee), or to another subsidiary (a cross-stream guarantee), unless the guarantor receives all or a proportionate share of the proceeds of the indebtedness, the courts must examine the transaction to determine if the guarantor:

- (a) received reasonably equivalent value (which may include indirect benefits); and
- (b) became insolvent by the transaction.

To address the insolvency risk, the guarantee should include language limiting the aggregate obligation of the guarantor to that amount that would not render the guarantor insolvent at the time the guarantee was made. While this approach has the disadvantage of potentially limiting the amount which might be available from a guarantor as its net worth increases and leaves open the question of how much of the guarantor’s assets are available to be called on, it decreases the possibility that the guarantee will be determined to be invalid.

A fraudulent conveyance also includes transfers made with intent to hinder, delay or defraud creditors. However, a mere financial assistance transaction of itself should not invoke this liability.

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

In a U.S. bankruptcy case, creditors and interest holders are generally paid in the following order of priority in either a Chapter 7 (liquidation) or Chapter 11 (reorganization):

- (a) secured creditors up to the value of their collateral;
- (b) administrative and priority creditors;
- (c) unsecured creditors; and
- (d) shareholders, subject to the priority of their distributive rights.

Secured creditors have the highest priority only if they have valid, perfected and unavoidable liens and that priority only extends to the value of the collateral. A secured creditor is generally entitled to a return of its collateral or payment (which can be over time) equal to the value of its collateral, either of which would need to be court approved after notice to parties with an interest in the pledged collateral. If the collateral of a creditor is to be disposed of by the bankruptcy estate, the estate must provide the security holder with adequate protection (i.e., replacement collateral of equal value).



Any unencumbered assets are then paid to administrative creditors and priority creditors, which include:

- (a) the bankruptcy professionals' fees;
- (b) debts incurred during bankruptcy;
- (c) certain pre-bankruptcy employee wage claims; and
- (d) certain taxes.

To the extent any funds remain, they are paid to unsecured creditors on a *pro rata* basis with any remaining assets shared by the shareholders, in accordance with the priority of their claims.

In a Chapter 11 bankruptcy, a reorganization plan may not be confirmed unless it meets a series of criteria. Firstly, the reorganization plan must be deemed to be feasible by the court. It must also be approved by at least one class of creditors that is receiving property under the reorganization plan that is less than the full value of their claim as a result of the reorganization (unless these liquidation priorities are respected or the members of each priority class otherwise approve the plan). A reorganization plan also either:

- (a) requires the approval of the secured creditor class, or
- (b) provides the secured creditor class with property with a value equal to the lower of their secured claim or the value of the property securing their claim.

Finally a reorganization plan must provide each class of claimholders with property of the same value as they would receive if the company were liquidated and the assets distributed in accordance with the priorities set out above or the reorganization plan is approved by the class receiving less than the liquidation value.

While shareholders typically receive little in relation to their claims, the shareholders, if aligned with management, may be able to negotiate a plan that provides them with an interest in the reorganized company that is greater than the value of the assets they would receive in liquidation by leveraging their status as incumbent management and debtor in possession.

The bankruptcy trustee (or debtor in possession) has the power, known as the 'strong arm', to avoid any unperfected security interest. The bankruptcy trustee may also invalidate any transfer of assets or collateral for less than the reasonably equivalent value (a preferential transfer) made within 90 days of the filing of the bankruptcy petition, or within one year if made to an officer, director or other person or entity that controls, is controlled by, or under common control with the debtor. Bankruptcy trustees view their mandate as maximizing the bankruptcy estate for the unsecured creditors and therefore exert considerable effort challenging the perfection of security interests and analyzing potential preferential transfers.

## 20. What are the general U.S. tax considerations for a fund when undertaking a buyout?

A fund typically has different types of investors, such as:

- (a) U.S. taxable investors,
- (b) U.S. tax-exempt investors; and
- (c) non-U.S. investors.

Each of these groups of investors is likely to have different tax objectives and concerns. A fund that undertakes a buyout should be mindful of the U.S. tax classification of the buyout target (i.e., a flow-

through entity versus a corporation) and the impact of this tax classification on different investor groups. The fund should determine the most appropriate acquisition structure to acquire and hold the buyout target in light of the tax concerns of the investors and any covenants made by the fund to the investors to address and mitigate these concerns.

## Buyout target treated as a flow-through entity

### *General*

A buyout target that is treated as a flow-through entity for U.S. tax purposes may have the form of a limited liability company or a limited partnership. If the buyout target has one economic owner, it is disregarded as an entity separate from its owner for U.S. tax purposes (in the absence of a tax election to be treated as a corporation), so that the assets, liabilities and activities of the buyout target are treated as the assets, liabilities and activities of its owner.

If the buyout target has more than one economic owner, it is treated as a partnership for U.S. tax purposes (in the absence of a tax election to be treated as a corporation). As a partnership, the buyout target is not taxed at the entity level, and all of its income and losses pass through and are allocated to its partners/members. However, the buyout target has U.S. information filing obligations.

If the buyout target is treated as a partnership for U.S. tax purposes, the acquirer of the buyout target may request the buyout target to make a U.S. tax election known as a ‘Section 754 election’ (**Section 754 Election**) so that the acquirer can obtain a step-up in its share of the tax basis of the buyout target’s assets equal to the purchase price. A benefit of this step-up in its share of the tax basis is increased depreciation and/or amortization deductions for the acquirer, which the acquirer can use to offset income. If a Section 754 Election is made, basis adjustments stemming from that election and attributable to the acquirer’s interest in the buyout target would need to be calculated by the general partner or manager of the buyout target. Because these basis adjustments are often complicated, many general partners and managers of partnership targets may be hesitant to cause a partnership to make a Section 754 Election unless they are reimbursed for all accounting and legal costs incurred in calculating basis adjustments and maintaining basis records. A fund should therefore consider the advantages and disadvantages of a Section 754 Election (including potential out-of-pocket costs to reimburse the general partner/manager for accounting and legal fees) before deciding whether to request this election.

There are U.S. tax consequences for investors in the fund (which is also a flow-through entity) in relation to their allocable shares of the fund’s income received from the buyout target if the fund owns the buyout target directly, or indirectly through flow-through vehicles. The U.S. tax consequences to an investor depend on whether the investor is a U.S. taxable investor, a U.S. tax-exempt investor or a non-U.S. investor.

### *U.S. taxable investors*

Each U.S. taxable investor is required to take into account its distributive share of each item of the fund’s income, gain, loss, deduction and credit for each taxable year of the fund. U.S. taxable investors must report these items regardless of the extent to which, or whether, they receive cash distributions from the fund for the taxable year. It is possible that losses and expenses of the fund (including losses that flow up to the fund from the buyout target) could exceed the fund’s income and gain during a taxable period. The ability of a U.S. taxable investor to deduct its allocable share of any net loss from its taxable income from other sources may be subject to a number of limitations under U.S. tax laws. These limitations include those relating to ‘passive losses,’ amounts ‘at risk,’ capital losses, itemized deductions and limitations relating to ‘investment interest.’

If the fund subsequently makes any cash distributions to a U.S. taxable investor, that investor is not subject to U.S. tax on a distribution unless the amount of the distribution exceeds the investor’s tax



basis in the fund. The investor's tax basis in the fund will have been increased by allocations of income from the fund to the investor.

#### *U.S. tax-exempt investors*

U.S. tax-exempt entities are generally subject to U.S. tax on their 'unrelated business taxable income' (**UBTI**). UBTI generally arises from either:

- (a) an unrelated trade or business regularly carried on; or
- (b) from property to the extent that there is 'acquisition indebtedness' in relation to that property.

Certain types of passive income such as dividends, interest, royalties, certain rents, capital gains and certain other items are generally exempt from UBTI if that income is not derived from property in relation to which there is acquisition indebtedness during the taxable year in which that income is earned or, in the case of capital gain income, within the 12-month period ending on the date the property is sold.

If a U.S. tax-exempt entity owns an interest in a partnership, the activities of the partnership are attributed to the U.S. tax-exempt entity for purposes of determining whether the entity's distributive share of partnership income is UBTI. If a U.S. tax-exempt entity is a partner in a partnership that is treated as a flow-through entity for U.S. tax purposes, and that partnership owns property which is subject to 'acquisition indebtedness,' (as is the case in a leveraged buyout) or if a U.S. tax-exempt entity incurs 'acquisition indebtedness,' in relation to that entity's investment in a partnership, then all, or a portion, of the U.S. tax-exempt entity's share of the partnership's income (including dividends, interest, royalties, rents and capital gains) attributable to that property may be treated as UBTI.

A U.S. tax-exempt entity that incurs UBTI is taxed on that income at corporate tax rates. There is a risk that a U.S. tax-exempt entity may jeopardize its tax-exempt status if it is deemed to receive excessive UBTI as a result of being engaged in excessive commercial business activities. There is however no bright-line test to determine what 'excessive' means. Guidance on this matter is not found in the U.S. tax statutes or tax regulations, but rather is interpreted by application of case law and rulings. Some case law and rulings have interpreted 'excessive' to mean a level of anywhere from 10% to 33% of unrelated commercial activities.

A US tax-exempt investor in the fund may incur UBTI to the extent that:

- (a) the portfolio company's income is UBTI;
- (b) the portfolio company investment is disposed; or
- (c) the portfolio company's activities do not otherwise generate UBTI, but there is acquisition indebtedness in the structure that converts the buyout target's income into UBTI (for example, acquisition indebtedness at the buyout target level or the fund level, or the U.S. tax-exempt investor capitalizes its interest in the fund using debt proceeds).

#### *Non-U.S. investors*

Non-U.S. persons that are engaged (or deemed to be engaged) in a U.S. trade or business are subject to U.S. income tax payment and filing requirements on the income that is effectively connected with that U.S. trade or business. This is known as 'effectively connected income', or ECI (**ECI**). Non-U.S. individuals are generally taxed on ECI at a maximum rate of 39.6%, while non-U.S. corporations are taxed at a maximum rate of 35%. Non-U.S. corporations are subject to an additional 30% tax known as the 'branch profits tax' on ECI. The branch profits tax may be reduced however by an applicable income tax treaty (if a non-U.S. person qualifies for treaty benefits). If a non-U.S. person is a partner in a partnership that conducts a U.S. trade or business, the non-U.S. person is treated as engaged in that U.S. trade or business.

In addition to U.S. trade or business income, ECI includes gains from the disposition (or deemed disposition) by a non-U.S. person of a 'United States real property interest' (**USRPI**). An USRPI includes U.S. property as well as 'United States real property holding corporations' (i.e., U.S. corporations that have 50% or more of the fair market value of their assets consisting of USRPIs over a general 5-year test period). An interest in a partnership is also treated as an USRPI if:

- (a) 50% or more of the value of the partnership's assets consist of USRPIs; and
- (b) 90% or more of the value of the partnership's assets consist of USRPIs and cash or cash equivalents.

#### **FATCA**

If a non-U.S. person derives U.S.-source non-business income (i.e., non-ECI), such as dividends or interest, the non-U.S. person is subject to a 30% U.S. withholding tax on that income, unless the tax is reduced by an applicable income tax treaty. That income may also be subject to 30% U.S. withholding tax under recent U.S. legislation known as the Foreign Account Tax Compliance Act (FATCA). FATCA imposes a 30% U.S. withholding tax on 'withholdable payments' made to non-U.S. entities unless those entities comply with certain reporting requirements to disclose any U.S. owners. 'Withholdable payments' include:

- (a) U.S.-source dividends, interest, rents and other 'fixed or determinable annual or periodical income' paid after June 30, 2014; and
- (b) U.S.-source gross proceeds from the disposition of property giving rise to US-source dividends or interest and paid after December 31, 2016.

The FATCA withholding tax is not imposed on top of the 'regular' 30% withholding tax, so that a dividend distributed to a non-U.S. corporate investor is not subject to double withholding.

If the buyout target and the acquisition vehicles are all flow-through entities, a non-U.S. investor in the fund may incur ECI:

- (a) to the extent that the buyout target derives ECI;
- (b) on a disposition of the buyout target; or
- (c) on a disposition by the non-U.S. investor of its interest in the fund.

The non-U.S. investor in these circumstances would have U.S. tax payment and filing obligations.

#### ***Combination of U.S. taxable investors, U.S. tax-exempt investors and non-U.S. investors***

If a buyout target is a flow-through entity, a fund should assess its investor pool and determine the most appropriate acquisition structure to house the buyout target. A two-tier holding company structure (i.e., an acquisition company owned by a fund and the management team, and an acquisition subsidiary typically wholly-owned by the acquisition company) is a common structure used by funds to acquire a buyout target.

If a fund has a combination of U.S. taxable investors, U.S. tax-exempt investors and non-U.S. investors (which is often the case), the fund needs to determine how best to structure the acquisition vehicles to hold the buyout target from a tax perspective, to address the tax objectives and tax concerns of the investor groups. For example, UBTI-sensitive investors and ECI-sensitive investors generally would not wish to hold their investment in the buyout target through flow-through acquisition vehicles, whereas U.S. taxable investors typically do not wish to invest in underlying investments through entities treated as corporations for U.S. tax purposes because of the U.S. tax leakage associated with those entities. A fund may therefore consider offering UBTI-sensitive investors and ECI-sensitive investors the opportunity to invest through a separate alternative



investment structure that would use a ‘blocker’ entity treated as a corporation for U.S. tax purposes to invest directly or indirectly in the buyout target. U.S. taxable investors, U.S. tax-exempt investors that are not sensitive to UBTI, and non-U.S. investors that are not sensitive to ECI, would invest in the buyout target through a flow-through acquisition vehicle structure. In the alternative investment structure, the UBTI-sensitive investors and the ECI-sensitive investors would become shareholders of the blocker entity, and their income would generally consist of dividends and gains from the blocker entity.

U.S. tax-exempt investors should not be subject to U.S. tax on these dividends and gains as long as investors do not use debt proceeds to capitalize their interest in the blocker entity. Dividends derived by non-U.S. investors from the blocker entity generally should not be treated as ECI (although dividends would be subject to U.S. withholding tax), and gains derived by these investors also should not be treated as ECI if the blocker entity is not a USRPI.

U.S. tax-exempt investors and non-U.S. investors should be aware that the use of a blocker entity in a structure will result in a layer of U.S. tax leakage because the blocker entity will be subject to U.S. tax. Investors must therefore take this tax leakage into consideration when determining whether to invest through a blocker structure. A common technique to mitigate this tax leakage is to insert shareholder loans and/or third-party loans at the level of the blocker entity. If a loan is from a non-U.S. investor in the blocker entity, the loan could be structured so that interest payments to the non-U.S. investor are treated as ‘portfolio interest’ and exempt from U.S. withholding tax. A fund that offers blocker structures to investors to mitigate UBTI and/or ECI needs to assess whether to put debt into a blocker entity and whether to make any covenants and promises to do this in the fund documents.

## Buyout target treated as a corporation

### *General*

A buyout target that is treated as a corporation for U.S. tax purposes is subject to entity-level U.S. federal income tax at a maximum rate of 35%. It may also be subject to U.S. income tax in any state in which it carries on a business or otherwise has a nexus to that state. State income tax rates vary by state.

As discussed above, a two-tier acquisition vehicle structure (i.e., an acquisition company owned by a fund and the management team, and an acquisition subsidiary typically wholly-owned by the acquisition company) is a common structure used by funds to acquire a buyout target. If one or both acquisition vehicles are treated as corporations for U.S. tax purposes, and they hold at least 80% of the vote and value of the buyout target, the acquisition vehicle(s) and the buyout target may elect to be treated as one consolidated tax group and file group tax returns. The consolidated taxable income of the group is subject to U.S. federal income tax (at a maximum rate of 35%) and state income tax. An election to file consolidated tax returns helps streamline the U.S. tax compliance efforts, but the trade-off is that the entities are required to abide by the U.S. consolidated group tax rules, which are extremely complex.

If an acquisition vehicle treated as a corporation for U.S. tax purposes acquires at least 80% of the vote and value of the buyout target in a 12-month period, the acquisition vehicle may be able to obtain a step-up in the tax basis of the assets of the buyout target equal to the purchase price through a special U.S. tax election known as a ‘Section 338 election’ (**Section 338 Election**). A buyer that makes a Section 338 Election is treated as acquiring assets for U.S. tax purposes. A basis step-up from a Section 338 Election gives increased depreciation and amortization deductions to the acquirer and these deductions may be used to offset income. Section 338 Elections may result in adverse tax consequences to a seller, however, and therefore sellers often demand to be compensated for any differences in their tax liability between a transaction without a Section 338 Election and a transaction with a Section 338 Election. A fund therefore should consider the advantages and disadvantages of a

Section 338 Election, including the potential need to reimburse/indemnify a seller for taxes, before deciding whether to proceed with a Section 338 Election.

If both acquisition vehicles are flow-through entities for U.S. tax purposes, income from the buyout target would flow through the acquisition vehicles to the fund, and from the fund to the investors. The buyout target would not be part of any consolidated tax group with the acquisition vehicles, and would file standalone tax returns.

Income arising from the investment would typically consist of distributions from the buyout target such as distributions of sale proceeds, refinancing proceeds or distributions of operating cash flow. If an acquisition vehicle is treated as a corporation for U.S. tax purposes, the investors indirectly receive (through the fund) corporate distributions from the acquisition vehicle. Corporate distributions are treated in the following order under U.S. tax laws:

- (i) firstly, as a dividend to the extent of a distributing corporation's current and accumulated earnings and profits;
- (ii) secondly, as a return of a shareholder's capital in the distributing corporation; and
- (iii) lastly, as capital gain from the shareholder's deemed disposition of its interest in the distributing corporation.

The impact of this treatment on investors in the fund is set out below.

#### *Dividend treatment*

Dividends are generally taxed at a maximum rate of 20% to U.S. individual investors and 35% to U.S. corporate investors. Dividends received by a non-U.S. investor are subject to a 'regular' 30% U.S. withholding tax, which may be reduced by an applicable income tax treaty if the recipient investor qualifies for treaty benefits. Furthermore, dividends to a non-U.S. corporate investor may be subject to a 30% U.S. withholding tax under FATCA (as discussed above). The FATCA withholding tax is not imposed on top of the 'regular' 30% withholding tax, however, so that a dividend distributed to a non-U.S. corporate investor is not subject to double withholding.

Dividends received by a U.S. tax-exempt investor are not subject to U.S. income tax unless the investor capitalized its interest in the fund in whole or in part with debt proceeds, or the fund capitalized its interest in the acquisition vehicle structure in whole or in part with debt proceeds. In those circumstances, all or a portion of the dividend distributions to the U.S. tax-exempt investor is treated as UBTI and is subject to U.S. income tax in the hands of the investor at corporate rates. The maximum corporate rate is 35%.

#### *Return of capital*

Return-of-capital distributions are treated as made to a shareholder in exchange for the shareholder's disposition of interests in the buyout target. The distributions are not subject to U.S. income tax.

#### *Capital gain*

U.S. individual investors are subject to U.S. tax at 20% (if the interests in the buyout target or the acquisition vehicle, as applicable, have been held for over one year) on their shares that have made a capital gain (through the fund). U.S. corporate investors are subject to U.S. tax at 35% on the capital gain. Non-U.S. investors are generally not subject to U.S. tax unless the buyout target (or acquisition vehicle, as applicable) is a USRPI.

If a buyout target is a corporation, it is effectively a blocker entity in that it blocks any UBTI and ECI from the U.S. tax-exempt investors and non-U.S. investors, respectively, in the fund (i.e., the buyout target is itself taxed on any UBTI or ECI that it generates). Therefore, funds typically acquire and



hold the buyout target through acquisition vehicles that are flow-through entities or treated as a single consolidated group to avoid creating additional tax leakage.

### Other U.S. tax considerations

There are several other U.S. tax considerations that a fund should consider when undertaking a buyout. Even though the taxes described below should not be directly imposed on the investors in the fund, the investors will nevertheless be economically impacted if any of these taxes is imposed in connection with a buyout.

#### *Sales tax*

While the U.S. does not employ a value-added tax regime, certain states, counties and municipalities do assess a sales tax on the value of goods sold to a final purchaser and use taxes on the value of goods acquired for use in the production of other goods. States have been more vigilant in enforcing sales and use taxes, and therefore potential target company liability for unpaid taxes has become a significant issue in U.S. buyouts. States may also assess a sales tax on the value of assets transferred in an asset sale.

#### *Stamp duty/transfer tax*

In addition to sales and use taxes, many states, counties and municipalities impose stamp and/or transfer taxes on deeds transferring title to real property or on mortgages or security interests in real property and, in some instances, on the transfer of stock in an entity holding real estate. Some states also assess stamp taxes on other contracts concluded in the state evidencing an obligation to pay money such as promissory notes, loan agreements and personal property security instruments. A bidder should therefore undertake a state and local tax analysis before concluding any acquisition in the U.S.

#### *Employment tax*

U.S. employers are responsible for withholding payroll taxes, including income tax withholding, unemployment insurance contributions and social security contributions. Failure to properly withhold and pay over those amounts can lead to significant penalties for the withholding agent and potential personal and criminal liability for the officers of the company. Withholding is a particularly significant issue in technology companies and service firms, where entering into consulting agreements with individual contractors is a common practice.

## 21. What forms of exit are available?

If a portfolio company is solvent, the most common forms of exit are a public offering of the common stock of the portfolio company or a sale of the portfolio company to financial or strategic buyers (either a sale of shares or a sale of the underlying business). Recapitalizations are also typical, allowing the fund to take a dividend from loan proceeds to reduce or recover its equity investment in the portfolio company. The preferred stock may also have a provision allowing the holder to require the portfolio company to redeem the stock from the holder after some period of time at a set price. This provision is not as typical in a buyout sponsored by a single fund but may be a feature of preferred stock issued in connection with a consortium bid.

## Venezuela

### 1. What structures do private equity funds typically use to manage their funds?

Foreign funds constituted in the form of a limited partnership in an offshore jurisdiction are the most active investors in the Venezuelan private equity market, with entities commonly used to hold investments in Venezuelan entities incorporated and domiciled in countries having both a double taxation treaty and a bilateral investment protection treaty with Venezuela (i.e., Switzerland and Spain, among others).

It is also common for private equity funds to invest using the Venezuelan corporate structures set out below:

- (a) a corporation, which is the preferred legal entity because its obligations are supported by a stated capital, and the shareholders' liability is limited to the amount of their capital contributions. Although the initial amount of the capital stock of a corporation is unlimited, it must be subscribed for in full, and at least 20% paid in on incorporation;
- (b) a limited liability company, which is an entity whose capital is divided into participations referred to as quotas. Under no circumstances may the quotas be represented by shares or marketable securities. In a limited liability company, the subscribed capital must be between VEF 20 and VEF 2,000 (approximately USD 3317 at the official rate of exchange of VEF 6.3 per USD). Because of this limitation, limited liability companies are seldom used in Venezuela;
- (c) a stock limited partnership which is an organization in which the ownership of the limited partners is divided into shares. The rules applicable to limited partners are essentially the same as those applicable to corporations. However, partnerships are seldom used in Venezuela; and
- (d) a limited partnership which is an entity in which the liability of the general partners is unlimited and the liability of the limited partners is limited up to the amount of their subscribed capital. The personal liability of the general partners is subsidiary. Therefore, no action can be taken against any of them personally, without first having exhausted remedies against the partnership.

Venezuelan Law also regulates collective investment entities, which include mutual funds, real estate funds and risk capital funds. However, these entities necessarily involve a public offering of their investment units and are subject to governmental licenses and supervision and, therefore, do not qualify as private equity funds.

Generally speaking, a corporation is the most frequently used and the most appropriate entity since it does not have any limitations in the capital stock, and limitations of liability of shareholders are preserved. However, for tax planning purposes, when other jurisdictions are involved, a limited liability company or a stock limited partnership (e.g., for U.S. check-the-box election) might be more appealing.

### 2. Do funds need to be licensed by any regulatory authority to conduct business in the jurisdiction?

Usually, a foreign private equity fund investing through a corporation or a limited liability company is not required to be licensed by any regulatory authority to conduct business. However, there are certain formalities that the foreign private equity fund should comply with and these are set out in the answer to question 3.



The collective investment entities referred to above however must be authorized by the National Securities Superintendence (SNV) and registered with the National Securities Registry (RNV).

### 3. Are there any approvals required for investments by foreigners in the jurisdiction and, if so, what is the process?

#### Foreign investment restrictions

##### *General*

As a general rule, Venezuelan foreign investment legislation does not prohibit or restrict the participation of foreign investment in any type of business activities in Venezuela. There are, however, some areas in which foreign investment is either totally prohibited or limited to a certain minority interest (e.g., investments in the oil industry).

Investments in television and radio broadcasting, Spanish language newspapers and the licensed professions (such as public accountants) are reserved to national companies. To render other telecommunications services, foreign investors must be domiciled in the country, unless otherwise stated in international agreements or treaties entered into and ratified by Venezuela, and request from the National Telecommunications Commission (CONATEL) an administrative authorization, as well as a concession if they want to occupy and use the radio-electric spectrum.

That being said, note that a new Foreign Investments Law (**Foreign Investments Law**) enacted on November 18, 2014 substantially modifies the regime and treatment of foreign investments in Venezuela. The Foreign Investments Law declares matters of foreign investments of public interest, eliminates the possibility of submitting to arbitration disputes regarding foreign investments and establishes the National Center of Foreign Trade (**CENCOEX**) as the new authority regarding foreign investments.

Along with CONCOEX, there are other governmental agencies that register foreign investments. For example, foreign investments in the:

- (a) banking sector must be registered with the Superintendent of Banks and Other Financial Institutions (**SUDEBAN**);
- (b) insurance and reinsurance sector must be registered with the Superintendent of Insurance (**SUDESEG**);
- (c) oil sector must be registered with the Ministry of People's Power for Energy and Petroleum; and
- (d) mining sector must be registered with the Ministry of People's Power for Basic Industries and Mining.

##### *Registration requirements*

All foreign investments made in Venezuela should be registered with CENCOEX. In order to register, the foreign investor (as defined in the Foreign Investments Law) must submit, among other requirements, evidence to CENCOEX that foreign exchange, tangible property or technology has entered the country to be contributed to a local company. (Note that the Foreign Investments Law provides that the value of the foreign investment must be represented by 75% of the tangible or physical assets.) In addition, the minimum amount for the purposes of obtaining the registration of a foreign investment is the equivalent of USD 1 million calculated at the official exchange rate in force at the time of the investment.

Once the investment has been registered, the foreign investor keeps its CENCOEX registration current by giving notice of any modification to the investment. Nevertheless, it is not clear what happens to investments lower than USD 1 million that have not been authorized by CENCOEX, and

what would be the legal status of that investment considering that the rights of foreign investors will only be enforceable from the date on which CENCOEX registers the foreign investment.

In general, registered foreign investors have the same rights as national investors. In terms of the repatriation of dividends, a foreign investor with registered foreign investments is entitled to remit dividends and repatriate capital abroad annually, in foreign currency, and starting from the closing of the first fiscal year, up to 80% of the profits or dividends derived from the registered and updated foreign investment. Foreign investors having a registered and updated foreign investment may also repatriate 85% of the proceeds arising from the liquidation of the local company provided that the 'liquidation' is a consequence of the sale of the company directly to national investors.

## Foreign exchange controls

Venezuela has recently introduced a new foreign exchange system that, at least from a regulatory standpoint, is intended to liberalize the existing currency exchange regime. The new system, among other things, allows individuals and legal entities in the private sector to engage in currency exchange transactions and eliminates certain existing restrictions or penalties in relation to exchange control transactions settled through it. In practice, however, in view of the Venezuelan current circumstances, individuals and legal entities are facing important limitations to purchase foreign currency through this mechanism, as well as the other two official mechanisms in place in order to remit funds abroad. Please note that certain government sources have indicated that a modification of the exchange control regulations and the currency exchange mechanisms is currently under discussion.

## 4. Who are the relevant regulators in the jurisdiction and how much interaction would one generally expect when undertaking a buyout?

With regard to buyouts in a regulated Venezuelan industry (e.g., banks, insurance, and telecommunications), prior notifications or even prior authorizations of the relevant regulatory agency may be required before action is taken.

The relevant Venezuelan regulatory agencies include:

- (a) the National Center of Foreign Trade (**CENCOEX**) - the new governmental agency responsible for regulating foreign investment and enforcing the applicable regulations in Venezuela;
- (b) the Office of the Institutions of the Banking Sector (**SUDEBAN**) - responsible for regulating, supervising and controlling the banking industry;
- (c) the Office of the Superintendent of Insurance (**SUDESEG**) - regulates, supervises and controls the insurance and reinsurance industries;
- (d) the National Securities Superintendence (**SNV**) - regulates, supervises and controls the public offering of securities as well as the activities of securities brokers, financial advisors and, generally speaking, all aspects and participants in the Venezuelan capital markets;
- (e) the National Tax Authority (**SENIAT**) - responsible for the collection of national taxes and customs;
- (f) the National Telecommunications Commission (**CONATEL**) - regulates, supervises and controls the telecommunications industry in general; and
- (g) the Antitrust Superintendence - reviews buyouts in terms of their compliance with the applicable competition law.

Note that there is no specific company/corporate regulator in Venezuela, although there are various commercial registries responsible for incorporating companies.



The level of involvement of each of these regulators depends on the transaction and must be analyzed on a case-by-case basis. In regulated industries, special laws do impose, in certain circumstances, reporting or filing requirements and, in some cases, they even impose the need to obtain prior authorization from the corresponding regulator before the acquisition can take place. For example, in relation to a buyout of a bank or another financial institution regulated by the Venezuelan Banking Law (**Banking Law**), any direct or indirect acquisition of shares by which the acquirer acquires directly or indirectly 10% or more of the capital stock or the voting rights will trigger the need to obtain the prior approval of SUDEBAN. In addition, the Banking Law sets out other thresholds that trigger certain reporting requirements to SUDEBAN for acquiring financial institutions. Therefore, the regulatory limits, implications and requirements of each proposed acquisition must be analyzed on a case-by-case basis.

## 5. How are buyouts typically undertaken in the private and the public markets?

### Private companies

A buyout in the private market is usually undertaken by a negotiated acquisition of a private company. The obligations and liabilities of the parties are regulated by the respective sale and purchase documents for a sale of shares or a sale of assets, as the case may be. In some regulated industries, additional regulatory requirements could apply.

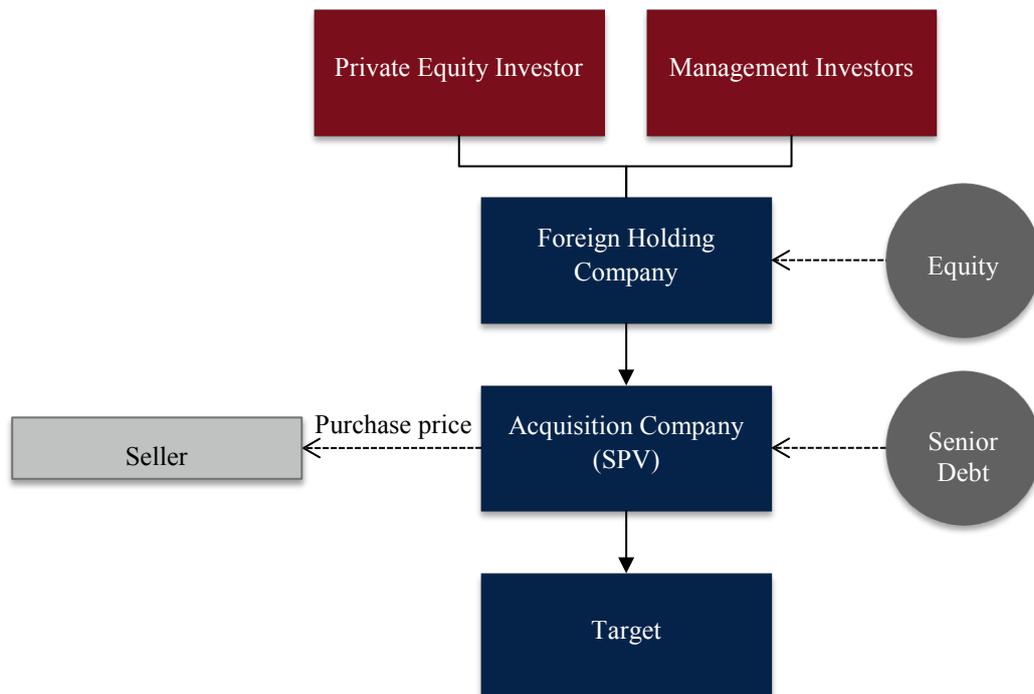
### Public companies

Public takeovers are regulated in the Venezuelan Capital Markets Law and in the Regulations for the Public Acquisition, Exchange and Takeover Offerings of Corporations making a Public Offering of Shares (**OPA Rules**) issued by the SNV. According to these regulations, any person that intends to acquire, in a single act or in successive acts, either directly or indirectly, shares representing more than 10% of the capital stock of a public company, must comply with the procedures established by the SNV for either a Public Acquisition Offering (PAO), Public Exchange Offering (PEO) or a Public Takeover Offering (PTO). The mechanism to be used for the acquisition of a stake of this type includes private negotiations and acquisitions through the stock exchanges.

An individual who has not complied with the applicable procedures for purchasing a stake of this type will not be entitled to exercise the rights derived from the shares acquired.

## 6. What is the typical corporate structure used when doing a buyout?

Usually buyouts are carried out by a foreign holding company with a direct interest in the Venezuelan company, or a Venezuelan holding company. Tailor-made arrangements and structures are possible in order to suit the parties regarding the relevant tax implications.



## 7. What transaction documentation is usually prepared when undertaking a buyout?

### Corporate

A sale and purchase agreement of the shares or assets is the main document. There may be ancillary documents such as a shareholders agreement or an escrow agreement. In the case of a public takeover, a public offering prospectus must be prepared.

### Banking

Usually, no further specific banking documentation is prepared when undertaking a buyout, unless financing is involved. In the case of financing, a range of agreements such as syndicated loan agreements, bridge loan agreements and mezzanine agreements may be used.

## 8. What forms of buyer protection can a fund usually expect when undertaking a buyout and where does that protection come from?

In private deals, negotiated warranty and indemnity coverage is usually obtained from sellers both for share and asset sales, with threshold and caps, time limits and price adjustments typically used. These mechanisms are also used in a bidding process. Warranty & indemnity insurance is not used in Venezuela. Escrow arrangements (*fideicomisos*) are common, as well as pre-closing covenants, break-up fees and indemnities.



## 9. Do laws exist regulating how conflicts of interest are managed in a typical management buyout?

There are no specific laws regulating conflicts of interest in a typical management buyout in Venezuela. However, under article 269 of the Venezuelan Code of Commerce (**Commercial Code**), if a director of a company has a conflicting interest in a certain transaction, he or she must declare the conflicting interest to the board and abstain from taking part in the deliberations concerning the matter.

Under Venezuelan commercial law, directors have a duty of care and loyalty to, and must act in the best interests of, the company. However, this concept is not as developed in Venezuela as it is in common law jurisdictions and it is very likely that if questioned in court, a Venezuelan judge will decide that the company's interests are the same as the interests of the shareholders.

The use of management/transaction protocol letters is not common in Venezuela. Conflicts due to the contractual obligations participating management owes to the target company under any service/employment agreement are handled on a case-by-case basis depending on the applicable contractual conditions and labor obligations.

Under the Capital Markets Law, the director of the SNV is responsible for resolving conflicts of interest that may arise from the procedures governed by the Capital Markets Law.

## 10. How are the equity arrangements typically regulated in a buyout?

Equity arrangements are regulated typically in shareholders agreements between the acquisition vehicle, the funds/investors providing the equity, managers invited to invest in the acquisition vehicle alongside the fund or funds and any existing shareholders who are retaining an interest in the target company. In addition, the articles of association or bylaws are also amended to reflect the terms of operation of the acquisition vehicle and the rights attaching to its shares.

Shareholders agreements are valid and enforceable instruments between the parties involved. There might be some problems in relation to enforcing the shareholders agreement against the company and therefore, it is advisable, to the extent possible, to incorporate the main provisions of the shareholders agreement into the articles of association or bylaws of the company. Note however that the articles of association/bylaws are documents that must be registered with the Commercial Registry and are therefore publicly available. Therefore, it is always advisable to review which conditions of the transaction should be kept private and to reflect those provisions in a separate (private) document (e.g., in the shareholders agreement).

## 11. What classes of equity security can be granted and what level of 'rights tailoring' can occur among different stakeholders?

The level of rights tailoring under Venezuela law is very flexible. A corporation may issue:

- (a) common shares, which grant ordinary rights to shareholders (right to vote, to receive dividends, to negotiate shares, etc.); and/or
- (b) preferred shares, which grant to their holders additional economic rights.

## 12. What laws exist in relation to board constituency, differential director voting rights and the removal of directors?

Generally, board constituency and directors' voting rights are not regulated by law, but by the articles of association/bylaws of the company. There is flexibility in relation to differential voting rights. However, in the absence of provisions in the articles of association, Venezuelan commercial laws will

be triggered, which in general terms require a simple majority for all corporate voting. There are certain special majorities for special decisions (e.g., liquidations, mergers).

The board of directors of companies whose shares are registered with the RNV must have at least 20% independent directors. Special regulations may apply to the regulated industries (for example, oil and gas industries which are subject to specific requirements).

### **13. What measures are commonly used to give a fund some level of control over key operating and financial decisions made by a portfolio company?**

The most common method used to give a fund some level of control over key operating and financial decisions made by a portfolio company is to establish controls in the articles of association/ bylaws of the company, which are publicly accessible at the Commercial Register. Prior authorizations of the board of directors for certain financial operations and major transactions are frequently required in the articles of association/bylaws. Covenants may be used as well.

Additionally, and in connection with the appointment of directors in the target company by the fund, it was usual for that entity to appoint directors to the board of the target company. However, due to the current legal environment and Venezuelan legislation, this practice has been gradually abandoned.

Veto rights are commonly used, and it is also typical for the fund to require detailed financial and operating information in relation to the target company so that it can closely monitor performance.

### **14. What employment terms are generally imposed on management in a buyout?**

When it is convenient or necessary for current management to remain, providing services at least for a certain period, an employment agreement is usually executed providing for certain elements of compensation, benefits or incentives previously agreed on, including, without limitation, performance or target bonuses. In certain cases, a stated term or guarantee of employment for a specific period is offered, provided that the executive does not incur a serious breach of his or her employment obligations during the term or period. Venezuelan labor legislation and principles must be observed in all of these agreements or offers. They should be carefully reviewed and analyzed with legal counsel prior to finalizing an employment agreement.

### **15. What equity incentives can be offered to management and how are they typically structured?**

There are no specific limitations in the Venezuelan labor legislation with respect to the types of equity incentives that can be offered to management. Stock options, restricted stock units and other similar equity incentives could be offered. Venezuelan labor legislation and principles must be observed in all of these equity incentives. They should be carefully reviewed and analyzed with legal counsel prior to offering equity incentives to the corresponding executives because they are always a delicate issue.

Venezuelan labor provisions are mostly of a mandatory nature. Therefore, the parties cannot negotiate the terms of the employment relationship. For example, certain mandatory indemnifications are due to employees. Also, certain registrations must be performed (e.g., social security). In connection with incentives in an MBO scenario, there may be stock option plans as well as bonuses for performance. However, this must be reviewed on a case-by-case basis.

### **16. How are buyouts typically debt financed and secured?**

Bank debt is the most frequently used debt financing, the terms of which vary, depending on the transaction and prevailing market conditions.



In order to secure repayment of the acquisition debt, there might be a subsequent merger with the target company. Alternatively, the target company and/or its subsidiaries may:

- (a) grant a guarantee or a security interest in favor of the creditors;
- (b) constitute themselves as joint obligor of the acquisition debt before creditors; or
- (c) enter into a debt assignment with investors by which the target company will become the new obligor in relation to the acquisition debt.

Venezuelan laws and regulations distinguish between guarantees and security interest in assets. A guarantee is an unsecured promise by a third party guarantor to the creditor to pay the debtor's obligation. The most common types of guarantees are general guarantees or bonds, and guarantees of negotiable instruments. A security interest in property involves the perfecting of a lien on specific assets. The most common security interests in relation to property are the mortgage of real property, the civil law pledge, the special pledge, and the chattel mortgage.

## 17. Are there financial assistance issues to consider when undertaking a buyout?

Venezuelan law contains no statutory provision limiting or prohibiting a company incorporated and domiciled in Venezuela from providing financial assistance in connection with the acquisition of shares in itself or its parent company (either direct or ultimate).

However, the company's corporate authorization of a transaction by which it provides financial assistance must be reviewed based on the content of its articles of association/ bylaws. If the company is a special entity (bank, insurance company, public issuer of securities, among others), a state-owned corporation or any other public sector entity, specific research is required to determine if there is any prohibition or limitation on providing financial assistance. This is due to the fact that special entities, public entities and corporations owned and/or controlled by the republic, the states or other Venezuelan public entities are heavily regulated.

## 18. What are the implications under the corporate benefit laws of Venezuela for a company providing financial assistance?

Venezuelan law regulates as follows the duties of a director of a Venezuelan company, and in particular, the situations that can give rise to personal/criminal liability.

### Directors duties

The scope of potential civil liability is set out below in relation to the director's relationship with, and responsibility to, each of the following categories of persons/entities:

- (a) the company itself;
- (b) the shareholders of the company (in their capacities as individuals); and
- (c) third parties who the director deals with on behalf of the company.

Also, there are several laws providing for criminal liability that a director of a company risks incurring in the exercise of his/her office. While some crimes expressly require that the perpetrator be a director and/or manager of the company, other crimes, even if perpetrated by any other officer of the company, imply a special risk for directors and/or managers, because they relate to the activities in which managers would usually engage in. Criminal liability of corporate directors is mainly covered by the provisions of the Commercial Code. However, there are many laws and regulations in other areas such as banking, tax, customs, narcotics, intellectual property, consumer protection, labor,

environmental and antitrust, which contain provisions in relation to possible criminal liabilities for corporate directors.

#### *Directors' relationship with the company*

Under Article 243 of the Commercial Code, a contractual relationship exists between a company and a director of that company. A director is liable to the company for damages resulting from a breach by the director of the terms and conditions of that contract under Articles 1,264 and 1,689 of the Venezuelan Civil Code (**Civil Code**).

The terms and conditions of the director-company relationship are those specifically set out in the articles of association/bylaws of the company, as well as those arising from specific statutory provisions. Directors may not exceed the powers conferred on them under the articles of association/bylaws of the company. If the directors attempt to exercise unauthorized powers, they will be liable to the company (as well as to affected third parties) for any harm caused by the unauthorized action.

Venezuelan law imposes on corporate directors affirmative obligations of diligence and good faith in the conduct of corporate affairs. Article 1,160 of the Civil Code provides that contracts (including directors' obligations to their companies) must be performed not only in strict compliance with their terms, but also in accordance with principles of equity, usage in the trade and the law. Articles 1,270 and 1,692 of the Civil Code provide that corporate directors, as parties to an implied contract of mandate (which is a contract under which one party agrees to perform certain acts for another person), must exercise the degree of diligence in the conduct of corporate affairs that a 'good father of a family' would exercise in the conduct of the family's affairs. This admittedly vague concept is analogous to the standard of conduct of a 'prudent man conducting his own affairs'. Therefore, under Venezuelan law, directors will not be liable for losses sustained by the company from decisions made or actions taken if:

- (a) those decisions were made or actions were taken in the ordinary course of the company's business; and
- (b) the directors have put in their best efforts (i.e., satisfied their duty of care and diligence) to seek to obtain a successful outcome in relation to those actions or decisions.

The Commercial Code also imposes certain affirmative duties and specific restraints on corporate directors in the conduct of the company's affairs. It appears that the purposes underlying these provisions of law are:

- (a) to assure proper shareholder supervision and control over the conduct of corporate affairs; and
- (b) to protect third parties in their dealings with the company.

Directors who fail to perform required duties or who act counter to specific restraints imposed by law are liable to the company for any losses suffered as a result of the relevant misconduct.

As noted above, the Commercial Code imposes certain restraints on directors' actions, largely to ensure the integrity of the corporate capital. Therefore, directors are prohibited from causing the company to purchase its own shares unless that purchase:

- (a) is specifically authorized by a shareholders' meeting; and
- (b) is made with funds provided for the purpose of purchasing its own shares from regularly obtained profits as shown in the company's financial statements.

Similarly, the directors may not declare dividends unless the company has sufficient retained earnings to pay those dividends. Finally, directors will be liable to any party (the company or a third party) that



suffers loss as a result of the directors making a false statement about the paid-in capital of the company.

Generally, all directors are jointly liable to the company for losses sustained as a result of a wrongful action of a director. A ‘wrongful action’ is a breach of a director’s fiduciary duty or any decision beyond the scope of the director’s powers. A director may, however, exonerate himself from liability by showing that he took no part in the misconduct and that he attempted to prevent it. To satisfy his burden of proof, the director seeking exoneration must show that:

- (a) he tried to dissuade the other directors from taking wrongful action;
- (b) his vote in opposition was duly recorded in the minutes of the meeting at which the wrongful action was taken or authorized; and
- (c) he immediately informed the statutory auditors of the other directors’ wrongful action.

It should be emphasized that it is not sufficient for a director to show that he took no part in the deliberations leading to the wrongful action; he must show affirmative efforts in opposition to the relevant action.

#### *Shareholders’ derivative action*

A resolution of a shareholders’ meeting is required to authorize legal proceedings against directors for breach of any obligations owed to the company. Venezuelan law makes no provision for an action by a shareholder, on behalf of the company (i.e., a shareholder’s derivative action), against the directors for harm to the company caused by director wrongdoing, and relevant legal authorities confirm that the right of a shareholder to maintain a derivative suit does not exist under Venezuelan law.

#### *Directors’ liability to third parties*

Since directors are responsible for representing the company in dealings with third parties, they may be exposed to liability to third parties who suffer harm in dealing with the company as a result of the directors’ misconduct. The three general categories of potential ‘victims’ are:

- (a) potential investors;
- (b) corporate creditors; and
- (c) parties entering into contracts with the company.

A director who provides false information about the company to the public is liable to any person harmed by that act. This liability is applicable in situations in which directors induce persons to invest in the company by providing them with false information or misrepresent the true facts about the company. Persons engaging in this form of misconduct may also be subject to criminal penalties.

Directors are legally responsible for the truth of any statements made regarding the paid-in capital of the company, for the existence of dividends paid, and for representations made to creditors. A director who violates any of these provisions in dealing with any third party, including any creditor, is liable for the harm suffered by his/her actions.

Directors may act on behalf of the company only within the scope of the authority granted to them by law and by the articles of association/by laws. The company is not liable to third parties for any obligation undertaken by the directors if undertaking that obligation is outside the scope of the directors’ authority. Although the company is not liable for the undertaking, the directors who acted beyond their authority are personally liable to any third party harmed by the undertaking of the relevant obligation. Therefore, if the directors cause the company to enter into a contract for which prior shareholders’ approval is required (but not obtained), the company is not bound by the contract, but the other party may proceed against the directors personally.

## 19. How do the insolvency laws operate as between secured and unsecured creditors and shareholders?

The insolvency proceedings available in Venezuela for non-regulated corporations are a moratorium or bankruptcy. Both proceedings are regulated by the Commercial Code. Banks and other financial institutions, as regulated corporations, are excluded from the moratorium and bankruptcy proceedings of the Commercial Code and are subject to special proceedings regulated by the Banking Law.

If there is a formal bankruptcy, certain transactions perfected within the ‘suspicion period’ may be void or voidable under the bankruptcy provisions of the Commercial Code. This suspicion period commences 10 days prior to the date of the suspension of payments as determined by the bankruptcy court and ends on the date of the bankruptcy decree. The bankruptcy court is allowed to establish that the date of the suspension of payments occurred as early as two years prior to the date of the bankruptcy decree.

In terms of the relationship between secured and unsecured creditors and shareholders, the general rule is that secured creditors rank ahead of unsecured creditors, who in turn rank ahead of shareholders. Secured creditors may foreclose secured assets in order to seek satisfaction of their claims, notwithstanding the moratorium or bankruptcy of the debtor. The proceeds of foreclosure will directly benefit the secured creditor and any excess will become part of the bankruptcy estate.

In the context of a bankruptcy proceeding, a creditor holding a security interest over specific property of the debtor is entitled to collect the amount of its secured claim from the proceeds of the judicial sale of the secured assets with preference over unsecured creditors. Creditors holding special civil law privileges (e.g., creditors having claims for legal expenses incurred during the proceedings to preserve the property for the benefit of all creditors and SENIAT) may in certain cases have priority over the secured lender.

A claim secured by a security interest must be paid in full before the proceeds of the foreclosed property may be distributed among unsecured creditors. Creditors having priority over specific collateral who are not fully satisfied from the proceeds of that specific collateral participate in the distribution of the proceeds of other assets of the debtor (with respect to their deficiency claims) as unsecured creditors.

## 20. What are the general domestic tax and duty considerations for a fund when undertaking a buyout?

In Venezuela, buyouts are generally carried out using holding companies rather than in the form of direct investments by the fund. Investors tend to use foreign holding company structures since Venezuela has entered into double taxation conventions with more than 30 countries. The final recommendation will depend on the specific facts.

The general key rules to take into consideration when undertaking a buyout in Venezuela are set out below.

### Deductibility of expenses and financing costs

#### *Deductibility of interest*

Corporate taxpayers are entitled to deduct, for income tax purposes, the interest paid either to local or foreign lenders under loans granted and invested in the acquisition of shares of a Venezuelan company, to the extent that the interest paid qualifies as normal and necessary to the borrower’s income-earning activities.



### *Thin capitalization rules*

Loans granted between related parties are subject to thin capitalization rules that establish a debt to equity ratio of 1:1. According to the thin capitalization rules, the amount of deductible interest is determined in two steps. Firstly, the average annual balance of the taxpayer's debts with independent parties should be subtracted from the average annual balance of net worth. If the result of this is positive, it will be divided by the annual balance of the taxpayer's debt assumed directly or indirectly with persons that are deemed to be related parties. If the quotient of this division is equal to or greater than one, the taxpayer may deduct the total amount from the interest paid directly or indirectly to related parties. If the quotient is less than one, the taxpayer may only deduct the amount resulting from multiplying the quotient by the total amount of interest paid directly or indirectly to persons that are deemed to be related parties.

### *Transfer pricing rules*

The Venezuelan transfer pricing rules allow SENIAT to control the manipulation of the import and export prices of goods and services, and the consideration for loans among members of the same economic group. The Income Tax Law defines related parties and sets out the method for determining the market price of goods and services among those related parties. The Income Tax Law follows, in general, the OECD Transfer Pricing Guidelines.

## Dividends

Dividends paid by companies incorporated in Venezuela are taxed at a flat rate of 34%, to the extent profits are not taxed at corporate level, unless a double taxation treaty provides a more favorable treatment. Dividends distributed by companies engaged in oil exploitation or mining activities are subject to a 50% and 60% rate, respectively.

The dividend tax is levied on the difference between the financial income and the net taxable income of the distributing company. To the extent that an element of income was subject to taxation at the corporate level, it will not be subject to further tax when distributed as a dividend. The amount of the taxable dividend will be calculated as follows:

- (a) the amount of the dividend; minus
- (b) the net taxable income of the company paying the dividend; minus
- (c) the exempt or exonerated income.

If the shareholder can benefit from the provisions of a double tax convention, the tax rate on dividends can be reduced from 34% (50% or 60%) to a series of reduced rates ranging from 0% to 15%, depending on the specific convention.

## Withholding tax

Income derived from interest is subject to back-up withholding at the source on payment or constructive payment by the buyer. There are three applicable interest withholding rates depending on whether the lender is a foreign financial institution, a foreign legal entity other than a financial institution, or an individual and/or a legal entity different from a financial institution domiciled in Venezuela (local financial institutions are not subject to income withholding tax).

The withholding rate applicable to:

- (a) foreign financial institutions is 4.95% of the gross interest amount;
- (b) non-domiciled legal entities is 34% of 95% of the gross interest amount (the effective rate is 32.3%); and

- (c) individuals and/or legal entities other than financial institutions domiciled in Venezuela is 34%.

If the lender can benefit from the provisions of a double tax convention, the withholding tax on the interest could be reduced to a series of rates ranging from 5% to 15%, depending on the relevant convention.

The withheld tax must be remitted to the Treasury by the buyer within three business days of the month following the payment or constructive payment. In the case of special taxpayers or 'large taxpayers', the withheld tax must be paid on the date provided in the special taxpayers' calendar.

Special taxpayers are individuals or legal entities with similar characteristics of income level or activities and that have been designated as such by SENIAT under Administrative Order No. 0685, 'Special Taxpayers Order,' published in Official Gazette No. 38.622 of 8 February 2007. Special taxpayers are closely scrutinized by the SENIAT, subject to special formal duties and must file their income and other tax returns and pay their taxes in accordance with the special calendar published annually by SENIAT, as mentioned above. They must also comply with their payment obligations at collection agencies authorized by the Revenue Service.

The sale of shares is also subject to income withholding tax applicable at the source on payment or constructive payment. The applicable withholding tax rate is 5% of the purchase price. The tax withheld must be paid to the Treasury within three business days following payment or constructive payment of the purchase price. Failure to withhold renders the buyer, as withholding agent, jointly and severally liable for the seller's income tax. Also, the buyer would be subject to fines and late payment interest. Shares traded through a domiciled stock exchange are subject to a 1% income withholding tax.

Dividends paid to shareholders are subject to total withholding tax at the time of the payment or constructive payment. The tax withheld must be paid to the Treasury by the corporation paying the dividends within three business days following the payment or constructive payment of dividends.

### Taxation on exit

Shares of a Venezuelan company are deemed to be Venezuelan *situs* intangible assets. Therefore, the sale or other disposition of shares is subject to the Venezuelan income tax rules, regardless of the domicile or place of incorporation of the parties, the place of execution of the purchase agreement or the currency or place of payment of the purchase price.

#### *Income tax/capital gain*

Under Venezuelan income tax rules, gain derived from the sale or other off-market disposal of shares is subject to Venezuelan income tax liability according to the following corporate rates:

- (a) 15% for net taxable income up to 2,000 Tax Units (TU);
- (b) 22% for the portion of net taxable income exceeding 2,000 TU up to 3,000 TU; and
- (c) 34% for the net taxable income exceeding 3,000 TU.

Currently, a TU is equivalent to VEF 150 (which converts to roughly USD 23.80 at the official rate of exchange of VEF 6.3 per USD or USD 0.85 at the SIMADI Rate (which currently fluctuates around VEF 176 per USD)).

The sale of shares of listed Venezuelan companies, the public offering of which has been authorized by the National Securities Commission, made through a domiciled stock exchange, is not subject to income tax liability according to these rates. Instead, it is subject to a flat tax rate of 1% on the gross sale price regardless of whether a gain or a loss is derived from the transaction.



The disposition of the shares will not be subject to income tax liability in Venezuela under most double tax conventions. In order to claim the benefits of a double tax convention, the seller must have available whenever SENIAT requests, a certificate of tax residence issued by the tax administration of the country of incorporation. The certificate must be translated into Spanish by an official translator and legalized or officially authenticated.

#### VAT

The sale of shares is not subject to Venezuelan value added tax liability as the sale of intangible assets does not give rise to Venezuelan value added tax.

#### Tax transparency regime (Controlled Foreign Corporations Rules)

The regime applies to investments held by taxpayers domiciled in Venezuela in branches, legal entities, real or personal property, shares, bank or investment accounts, or any form of participation in entities with or without legal capacity, trust funds, partnerships, investment funds or any other similar legal entity located in tax havens. In these cases, the entity is considered to be transparent for tax purposes and the taxpayer domiciled in Venezuela must declare as its own, on an accrual basis, the income, costs, and expenses of the entity and pay the corresponding tax. SENIAT has published a list of low-tax jurisdiction or tax havens commonly denominated as black-listed jurisdictions.

### 21. What forms of exit are available?

In a solvent situation, the most common exits are a negotiated sale or an IPO.

In an insolvent situation, there are no regulations that prevent shareholders from selling their shares in the company. However, once insolvency has been declared by the company, management of the company passes on to a liquidator.



## Baker McKenzie helps clients overcome the challenges of competing in the global economy.

We solve complex legal problems across borders and practice areas. Our unique culture, developed over 65 years, enables our 13,000 people to understand local markets and navigate multiple jurisdictions, working together as trusted colleagues and friends to instill confidence in our clients.

[www.bakermckenzie.com](http://www.bakermckenzie.com)

©2017 Baker & McKenzie. All rights reserved. Baker & McKenzie International is a Swiss Verein with member law firms around the world. In accordance with the common terminology used in professional service organizations, reference to a "partner" means a person who is a partner, or equivalent, in such a law firm. Similarly, reference to an "office" means an office of any such law firm.

This may qualify as "Attorney Advertising" requiring notice in some jurisdictions. Prior results do not guarantee a similar outcome.