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in 33 jurisdictions worldwide

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1 Types of private equity transactions

What different types of private equity transactions occur in your jurisdiction?

US private equity transactions may involve the acquisition by a private equity sponsor of a controlling stake in a private or public company, which is typically structured as a stock purchase, asset purchase, merger, tender offer or leveraged recapitalisation. Private equity sponsors may also make minority investments in public or private companies, which typically involve the purchase of common stock, preferred stock, convertible debt or equity securities, warrants or a combination of such securities. Private equity transactions involving the acquisition of a private or public company are generally structured as leveraged buyouts (LBOs) in which a significant amount of the purchase price is paid with the proceeds of new debt; this debt is usually secured by assets of the target and serviced from the cash flows of the target. In acquisitions of a public company, a private equity sponsor may engage in a going-private transaction, which typically involves a one-step merger or a tender offer followed by a merger. As discussed in question 4, going-private transactions subject to rule 13e-3 of the US Securities Exchange Act of 1934 generally require significantly greater disclosure than other types of private equity transactions.

2 Corporate governance rules

What are the implications of corporate governance rules for private equity transactions? Are there any advantages to going private in leveraged buyout or similar transactions? What are the effects of corporate governance rules on companies that, following a private equity transaction, remain or become public companies?

The Sarbanes-Oxley Act of 2002 and related Securities and Exchange Commission (SEC) and stock exchange rules raise a variety of issues relevant to private equity transactions, including those outlined below:

- if the target in a private equity transaction continues to have listed common equity, a majority of the target's board of directors, audit committee, nominating or corporate governance committee and compensation committee must meet stringent independence requirements;
- the New York Stock Exchange and Nasdaq Stock Market do not require 'controlled companies' (ie, companies in which more than 50 per cent of the voting power is held by an individual, group or another company) to maintain a majority of independent directors on the board or have a nominating or compensation committee comprising independent directors; however, controlled companies are still required to maintain an audit committee comprising entirely independent directors;
- in conducting due diligence on a public target, private equity sponsors must carefully review the target's internal financial controls and prior public disclosures to evaluate any potential liability for past non-compliance and to avoid stepping into a situation in which significant remedial or preventive measures are required;
- if a private equity sponsor requires management of a public target to purchase equity of the target or a new entity formed in connection with the transaction, the sponsor should be aware that a public target is generally not permitted to make loans or arrange for the extension of credit to any directors or officers of the target to fund such purchases;
- if a sponsor intends to finance a transaction with publicly traded debt, the target must have an audit committee comprising solely independent directors and must comply with enhanced disclosure requirements (eg, disclosure of off-balance sheet arrangements); and
- if a private equity sponsor intends to exit an investment following an initial public offering of the target's stock, the exit strategy must take into account the time, expense, legal issues and accounting issues that may arise in connection with becoming a public company.

A number of public companies consider going-private transactions in the light of the stringent US corporate governance regime and scrutiny of accounting and executive compensation policies and practices. Companies that do not have publicly traded equity or debt securities are exempt from complying with the corporate governance rules in the Sarbanes-Oxley Act and related SEC and stock exchange rules. Some of the advantages of a going-private transaction include the reduction of expenses relating to compliance and audit costs, elimination of public disclosure requirements and decreased risks of liability for directors and management.

3 Issues facing public company boards

What are the issues facing boards of directors of public companies considering entering into a going-private or private equity transaction? What is the role of a special committee in such a transaction where members of the board are participating or have an interest in the transaction?

When the board of directors (and any special committee, as described below) reviews a going-private or private equity transaction proposal, the directors must satisfy their fiduciary duties and their actions must satisfy the applicable 'standard of review' under applicable state law, which may affect whether the directors could be personally liable in any lawsuit that challenges the transaction. Other preliminary issues to be considered by the board of directors of a public company in considering a going-private or private equity transaction proposal include various disclosure issues. Generally, the board of directors will be consulted by management before the disclosure of confidential information regarding the target company to a prospective private equity investor pursuant to an appropriate confidentiality agreement, which may include 'standstill' provisions that prevent a sponsor and its affiliates from acquiring or making proposals to acquire any securities of the company without the board's prior consent. Note that, under US securities laws, a sponsor and its affiliates may be restricted from acquiring securities of a public company if the sponsor is in possession of material, non-public information with respect to such company. Also, as discussed in question 12, a board of directors must consider any fraudulent conveyance issues presented by the proposed debt to be incurred by the company in connection with the private equity transaction.

A critical threshold determination to be made by a board of directors regarding its consideration of a going-private or private equity transaction proposal is whether the board should form a special committee to consider and make decisions with respect to the proposed transaction. In Delaware (the leading US corporate jurisdiction), if participating management, other persons affiliated with the parties making a going-private or private equity transaction proposal (including any participating significant stockholders) or persons otherwise subject to a conflict of interest with respect to the proposal comprise a majority of a corporation's board of directors, the 'entire fairness' standard will apply – which places the burden on the board to show that the transaction was fair to the unaffiliated stockholders. To reach such determination, the transaction process and the resulting transaction price must be found to be fair. In the event that a transaction may be subject to the entire fairness standard, a board of directors will typically form a special committee comprising entirely disinterested directors to shift the burden of demonstrating entire fairness to the plaintiffs in any legal challenge to the transaction. The special committee should comprise solely disinterested directors, have the right to engage its own financial adviser and legal counsel and be authorised to independently negotiate and evaluate the transaction as well as alternative courses of action, including pursuing other acquisition proposals or continuing to implement the target company's strategic plan as a standalone company.

4 Disclosure issues

Are there heightened disclosure issues in connection with going-private transactions or other private equity transactions?

Generally, going-private transactions and other private equity transactions are subject to the same disclosure requirements under the US securities laws that are applicable to other merger and acquisition transactions. However, certain going-private transactions are subject to rule 13e-3 of the US Securities Exchange Act of 1934, which mandates significantly greater disclosure than is ordinarily required by the federal proxy rules or tender offer rules. Generally, rule 13e-3 will apply only if the going-private transaction involves a purchase of equity securities, tender offer for equity securities or proxy solicitation related to certain transactions by the company or its affiliates (which includes directors, senior management and significant stockholders); and will result in a class of the company's equity securities being held by fewer than 300 persons or a class of the company's equity securities listed on a stock exchange to no longer be listed. The heightened disclosure requirements applicable to going-private transactions subject to rule 13e-3 include, among other items, statements by the target and other transaction participants as to the fairness of the transaction to disinterested stockholders, plans regarding the target company, alternative transaction proposals made to the target, disclosure regarding control persons (eg, information about directors and officers of private equity sponsors) and information regarding the funding of the proposed transaction. Also, the target company will need to publicly file or disclose any report, opinion or appraisal received from an outside party that is materially related to the transaction and any stockholder agreements, voting agreements and management equity agreements. If the going-private transaction (whether or not subject to rule 13e-3) is structured as a tender offer or transaction requiring the vote of the target company's stockholders (eg, a cash or stock merger), the subject company's stockholders will be required to receive a tender offer disclosure document or a proxy statement or prospectus containing disclosure that satisfies the applicable US tender offer rules, proxy rules or Securities Act requirements (these generally require disclosure of all material information relating to the offer or transaction).

5 Timing considerations

What are the timing considerations for a going-private or other private equity transaction?

Timing considerations depend upon a variety of factors, including:
- the time necessary for the target's board or special committee to evaluate the transaction and any alternatives;
- the first date on which public disclosure of any proposal to acquire a public company target must be made if the proposal is being made by any person who has an existing schedule 13D or 13G filing;
- the time necessary for bank financing syndication, sales of debt securities, tender offers or consent solicitations relating to existing debt securities and any attendant delays;
- regulatory review, including requests for additional information from antitrust or other regulators;
- the magnitude of disclosure documents or other public filings and the extent of the SEC review;
- timing relating to solicitation of proxies, record dates and meeting dates in connection with a stockholder vote;
- timing relating to solicitation of tenders and other required time periods under the US tender offer rules (eg, tender offers must remain open for 20 business days);
- significant litigation related to the transaction; and
- the time necessary to establish alternative investment vehicles and special purpose vehicles or to complete a restructuring of the target prior to closing.

6 Purchase agreements

What purchase agreement provisions are specific to private equity transactions?

Historically, private equity sponsors negotiated for the right to condition their obligation to consummate the transaction upon their receipt of financing proceeds. In recent years, private equity buying groups typically have agreed to the elimination of a financing condition. In most of the transactions with no financing condition, private equity buying groups have agreed to pay a 'reverse termination fee' to the seller in the event that all of the other conditions to the closing had been satisfied and the buying group was unable to obtain the financing necessary to consummate the closing. The potential obligation to pay a reverse termination fee is typically supported by a limited guarantee from the private equity fund or by granting the seller a limited right to enforce an 'equity commitment letter' provided by the private equity fund to the shell acquisition vehicle, pursuant to which the fund committed to fund a specified amount to the acquisition vehicle at closing. Most agreements providing for a reverse termination fee include provisions that deem payment of such fee to be liquidated damages and otherwise cap the fund's liability exposure to a specified amount. Particularly in transactions involving third-party financing, private equity firms rarely agree to a specific performance remedy that may be enforced against the private equity firm or special purpose vehicle used in the transaction.

Participants on the other side of a private equity transaction (whether sellers or buyers) will frequently require evidence of the creditworthiness of any special purpose vehicles used in the transaction to ensure they have a sufficient remedy in the event that the vehicle breaches its obligations under a purchase agreement or is required to satisfy an indemnification obligation. Participants in private equity transactions may attempt to negotiate guarantees from a private equity sponsor, but most private equity sponsors resist indemnification, guarantee or other obligations that run directly to the private equity fund. However, in circumstances where a sponsor has agreed to pay a reverse termination fee, as described above, sponsors frequently agree to provide a limited guarantee of the payment of the reverse termination fee or provide the target company with a right to enforce the equity commitment letter from the sponsor to the extent of the reverse termination fee.

Both sellers and buyers in private equity transactions will generally seek to obtain fairly extensive representations, warranties and covenants relating to the private equity sponsor's equity and debt-financing commitments, the private equity sponsor's obligation to draw down on such financing and obtain any required alternative financing and the target company's obligation to assist with obtaining the financing. These types of provisions, as well as various other financing-related provisions, are discussed further in question 11.

7 Participation of target company management

How can management of the target company participate in a going-private transaction? What are the principal executive compensation issues?

In a private equity transaction, the management of a target company may be offered the opportunity (or be required) to purchase equity of the target company or an acquisition vehicle, which may be structured as a 'rollover' of existing equity holdings. Whether and to what extent such investments are made may depend heavily on the type and amount of the management's historic compensation arrangements as well as the amount, if any, of cash payments management will receive in the going-private transaction, in respect of current equity and equity-based awards and payouts under deferred compensation and other plans. In connection with such investment, management typically also receives equity incentive awards (eg, stock options in a corporation or profits interests in a partnership). These equity awards generally become vested based upon continued employment, the achievement by the company of specified performance targets, the private equity sponsor achieving a particular return on its investment or a combination of these conditions. These agreements also typically provide for acceleration of vesting, or forfeiture, of the equity incentive awards upon a termination of employment (the acceleration or forfeiture depends upon the reason for the termination of employment) and impose on the employees post-termination covenants not to compete with the business of the company and not to solicit company employees or clients. All equity acquired by an employee will typically be subject to a stockholders' agreement, which customarily includes transfer restrictions, a call right of the company upon the employee's termination of employment for any reason (with the call price varying based on the reason for the termination), drag-along and tag-along rights (which are described in question 13) and piggyback registration rights. Customary terms of shareholders' agreements are discussed in question 13.

Historically, one of the key concerns in a private equity transaction has been continuity of management under the theory that the private equity sponsor does not have any special expertise in operating the acquired business on a day-to-day basis. As such, the principal executive compensation issues in a private equity transaction relate to ensuring that equity-based and other compensation has been appropriately structured to provide an incentive to management to increase the company's value and remain with the company. To this end, primary questions involve whether management may rollover existing equity on a tax-free basis as part of their investment, the accounting and tax treatment (both for the company and management) of equity incentive awards and other compensation arrangements, and how management can achieve liquidity under their investment and equity awards. It should also be noted that other issues, such as ongoing employee benefit protections (eg, post-termination welfare and pension benefits) and certain compensation arrangements (eg, base salary and annual cash bonus opportunities), will factor into any private equity transaction negotiation with management of the target company.

As described above, management participating in a private equity transaction may have several opportunities to earn significant value (both in the primary transaction and upon a successful future exit event). As a result, shareholders of a public company engaged in a going-private transaction are particularly concerned about conflicts between management's desire to complete a transaction or curry favour with the new buyer, on the one hand, and shareholders' desire to maximise value in the transaction, on the other. In recent years, this issue has received significant attention, resulting in some boards of directors restricting their senior management from participating in certain aspects of going-private negotiations or discussing post-closing compensation arrangements with the private equity firm until after the sale has been completed. In addition, the SEC has required significant disclosure regarding management's conflicts of interests, including quantification of the amount to be earned by executives of the target company in the transaction.

8 Tax issues

What are the basic tax issues involved in private equity transactions? Give details regarding the tax status of a target, deductibility of interest based on the form of financing and tax issues related to executive compensation. Can share acquisitions be classified as asset acquisitions for tax purposes?

Many US private equity funds are structured as limited partnerships or limited liability companies, which are generally treated as pass-through entities for tax purposes. Private equity transactions are frequently structured in such a manner to avoid or minimise the effect of 'double taxation' that results from investing directly into entities that are treated as corporations for tax purposes. However, such 'flow-through' structures could create US tax issues for tax-exempt and non-US limited partners of private equity funds. Generally, the substantial amount of debt involved in LBO transactions affords a target company significant interest expense deductions that offset taxable income. Careful attention must be paid to the terms of the acquisition debt to ensure that the interest is deductible under applicable US tax rules.

Private equity sponsors must also be aware of tax issues relating to employee compensation. Severance and consideration for equity holdings in connection with a change of control may be considered 'excess parachute payments', which are subject to a 20 per cent excise tax (in addition to ordinary income taxes) and which may not be deducted by the target. If an award granted is an 'incentive stock option', no income is realised by the recipient upon award or exercise of the option and no deduction is available to the company at such times. If the award granted is a non-qualified stock option, no income is recognised by the recipient at the time of the grant and no deduction is available to the company at such time. There are a number of limitations on incentive stock options; accordingly, non-qualified stock options are more typical. If a deferred compensation plan is 'non-qualified', all compensation deferred in a particular year and in prior years may be treated as taxable income in such taxable year to the extent that it is not subject to substantial risk of forfeiture.

In transactions where cash is paid for the shares of a target corporation, a seller and buyer may agree to treat the acquisition of stock of a corporation as an asset acquisition for US federal tax purposes by making a 338(h)(10) election. This election leads to a 'step-up' in the target's tax basis in its assets to the purchase price paid for such shares, resulting in additional depreciation/amortisation deductions and a tax shield to offset taxable income. A 'qualified stock purchase' of the target's stock (generally an acquisition by a corporation of at least 80 per cent of the target's issued and outstanding stock) must be made to make this election. Certain typical structures used in LBOs (eg, rollover of management equity to a newly formed vehicle that purchases target stock) must be carefully analysed to determine whether such structures will render the 338(h)(10) election impermissible.

9 Existing indebtedness

What issues are raised by existing indebtedness at a potential target of a private equity transaction? How can these issues be resolved?

A private equity sponsor must determine whether a target company's existing indebtedness contains restrictions on changes of control that would require creditor consent, restrictions on subsidiary guarantees, restrictions on the granting of security interests in the assets of the target or its subsidiaries, restrictions on debt incurrences and guarantees and restrictions on dividends and distributions. A private equity sponsor must also determine the manner in which and the cost at which existing indebtedness may be repaid or refinanced and evaluate the cost of the existing indebtedness compared with acquisition-related indebtedness, as well as the requirements of its financing sources relating to existing debt, capitalisation and other financial ratios applicable to the target. Sponsors may require that certain debt of a target be repaid, redeemed, repurchased or amended as a condition to the closing of a transaction. In the case of public debt, sponsors may require the target to effect a consent solicitation to eliminate certain covenants in the governing indenture (eg, financial information delivery requirements).

10 Debt financing structures

What types of debt are used to finance going-private or private equity transactions? Do margin loan restrictions affect the debt financing structure of these transactions? Are there any other restrictions in your jurisdiction on the use of debt financing for private equity transactions?

LBOs generally involve senior bank debt, which is typically provided by commercial lending institutions in the form of a revolving credit facility and term loans (which are typically secured by the target's assets), and mezzanine debt, which is typically provided by private purchasers in the form of senior or senior-subordinated notes (or both), or by a public or rule 144A offering of high-yield bonds. In certain circumstances, mezzanine debt may be issued in conjunction with warrants to purchase equity in the target. Private equity transactions typically involve 'bridge-financing commitments' pursuant to which a commercial lending institution agrees to provide 'bridge' loans in the event that the mezzanine debt cannot be sold.

If a 'shell' company issues unsecured debt securities in a non-public offering with the purpose of acquiring the stock of a target corporation, such debt securities may be presumed to be indirectly secured by 'margin stock' (ie, any stock listed on a national securities exchange, any over-the-counter security approved by the SEC for trading in the national market system or any security appearing on the US Federal Reserve Board's list of over-the-counter margin stock and most mutual funds). If so, such debt would be subject to the US Federal Reserve Board's margin requirements and thus could not exceed 50 per cent of the value of the margin stock acquired. Private equity sponsors may avoid these requirements by utilising publicly offered debt or having the debt guaranteed by an operating company with substantial non-margin assets or cash flow.

11 Debt and equity financing provisions

What provisions relating to debt and equity financing are typically found in a going-private transaction? What other documents set out the expected financing?

Purchase agreements in a going-private transaction typically include representations and warranties by the private equity sponsor regarding the equity-financing commitment of the private equity sponsor and the debt-financing commitments obtained by the sponsor at the time of entering into the purchase agreement. An equity commitment letter from the private equity sponsor (as described in question 6) as well as the debt-financing commitment letters obtained by the sponsor from third-party lenders are customarily provided to the target company for its review prior to the execution of the purchase agreement. In US transactions, definitive debt-financing documentation is rarely agreed at signing; instead, the definitive debt-financing documentation is typically negotiated between signing and closing on the basis of debt-financing commitment letters delivered by third-party financing sources at signing. Purchase agreements in going-private transactions also contain covenants relating to obligations of the sponsor to use reasonable best efforts to negotiate definitive debt-financing agreements and obtain financing, flexibility of the sponsor to finance the purchase price from other sources and obligations of the target to co-operate in connection with the financing (eg, participate in road shows, and assist in the preparation of financial statements and offering documents).

A purchase agreement may (or may not) condition the closing of a transaction on the receipt of financing proceeds by the private equity sponsor, as noted in question 6. If the closing is not conditioned on the receipt of financing proceeds, the purchase agreement would typically provide for a 'marketing period', during which the private equity sponsor will seek to raise the portion of its financing consisting of high-yield bonds (and, in certain cases, syndicated bank financing), and which begins after the private equity sponsor has received certain financial information about the target company. If the private equity sponsor has not obtained the proceeds of such financing by the end of the marketing period (or has failed to obtain such proceeds from a 'bridge' financing) and thus fails to close the transaction, the private equity sponsor may be required to pay a 'reverse break-up fee' – which may function as a cap on the damages the company (on behalf of its stockholders) is permitted to seek from the private equity sponsor for its failure to close the transaction, as described in question 6.

12 Fraudulent conveyance and other bankruptcy issues

Do private equity transactions involving leverage raise 'fraudulent conveyance' or other bankruptcy issues? How are these issues typically handled in a going-private transaction?

Generally, under applicable US state laws, a company may not transfer assets for less than fair consideration in the event that the company is insolvent or such asset transfer would make it insolvent. Thus, in highly leveraged transactions, there is some concern that when a target company issues or transfers its assets or equity to a private equity sponsor in exchange for the proceeds of acquisition financing, which is secured by the assets or equity of such target company, the lender's security interests in such assets or equity securities may be invalidated on a theory of fraudulent conveyance (ie, the target company has transferred its assets for inadequate value). It is common for a certificate as to the ongoing solvency of the continuing company to be obtained prior to closing a leveraged transaction. Purchase agreements in leveraged transactions may also include representations and warranties as to the solvency of the company after giving effect to the proposed transaction.

Fraudulent conveyance issues should also be carefully considered by sellers in highly leveraged transactions. A board of directors considering a sale of the company should review the financial projections provided by management to a prospective buyer, and the indebtedness that the prospective buyer proposes the company incur in connection with the transaction, to evaluate any fraudulent conveyance risks. Directors of a target company must be particularly cautious in highly leveraged transactions in which the company has existing debt that will remain in place following the closing of the transaction. In Delaware (the leading US corporate jurisdiction), creditors of an insolvent corporation have standing to bring derivative actions on behalf of the corporation against its directors because, when a corporation is insolvent, creditors are the ultimate beneficiaries of the corporation's growth and increased value.

13 Shareholders' agreements

What are the key provisions in shareholders' agreements covering minority investments or investments made by two or more private equity firms?

Shareholders' agreements in connection with minority investments or 'consortium' deals typically include the right to designate a certain number of directors and the right to approve (or veto) certain transactions (eg, change in control transactions, affiliate transactions, certain equity or debt issuances, dividends). Private equity sponsors may also negotiate for pre-emptive rights to allow them to maintain the same percentage ownership after giving effect to a primary equity issuance by the target. In addition, shareholders' agreements frequently include transfer restrictions (which prohibit transfers of target securities for a particular time period and in excess of specified percentages, or both), tag-along rights (ie, the right of a shareholder to transfer securities to a person who is purchasing securities from another holder) and drag-along rights (ie, the right of a shareholder to require other holders to transfer securities to a person who is purchasing securities from such shareholder). Sponsors typically seek other contractual rights relating to their potential exit from the investment, such as demand and piggyback registration rights (which may include the right to force an initial public offering), put rights or mandatory redemption provisions. In certain circumstances, shareholders' agreements in private equity transactions may also contain 'corporate opportunity' covenants that either restrict (or in some cases, expressly permit) the ability of shareholders (including private equity sponsors) to compete with the subject company or make investments outside the subject company that may otherwise be a potential investment or acquisition opportunity for the subject company.

14 Limitations on transaction size

Do private equity firms have limitations on the size of transactions they may engage in?

A private equity fund may not engage in a transaction that requires equity capital in excess of the aggregate capital commitments of the fund. Furthermore, the partnership agreements of most private equity funds usually contain concentration limitations that restrict the size of any particular portfolio investment to a specified maximum percentage of total capital commitments (eg, 20 per cent). A private equity fund may rely upon debt financing or equity co-investments to make investments that exceed its per transaction capacity.

15 Exit strategies and investment horizons

How do the exit strategies and investment horizons of private equity firms affect the structuring and negotiation of leveraged buyout transactions?

A private equity sponsor will generally negotiate for as many 'liquidity' rights as possible in connection with an LBO transaction, which may include the right to require an initial public offering and the right to drag along other investors in the event of a significant sale by the sponsor. The ability to achieve a tax-efficient exit, the ability to avoid corporate-level tax at the target level and the ability to receive dividends and distributions in a tax-efficient manner will also be critical factors in determining the initial structuring of a transaction, including the use of acquisition financing or other special-purpose vehicles. In addition, the partnership agreement of a private equity fund limits the term of the fund, restricts the commitment period in which a fund may invest capital, limits the amount of capital available for investment and dictates the fund's ability to make follow-on investments. In circumstances in which a private equity firm is partnering with a strategic buyer in an acquisition, the private equity firm and the strategic buyer will likely need to negotiate with each other regarding the appropriate exit strategies and time frames for a potential disposition of the investment, as further described in question 19.

16 Principal accounting considerations

What are some of the principal accounting considerations for private equity transactions?

Similar to other business combinations, private equity transactions that involve the purchase of a controlling position in a company typically result in the use of the purchase method of accounting by the acquiring company. Under the purchase method, the acquirer is treated as having purchased the assets and assumed the liabilities of the target, which are then recorded at their current fair market values. The recording of the fair values could result in a write-up or a write-down as compared to the target company's carrying value or book value. The difference between purchase price paid and the identifiable assets acquired, net of the liabilities assumed (if any), would be attributed to goodwill. Identifiable assets include both tangible assets (eg, cash, accounts receivable, property plant and equipment) and intangible assets (eg, patents, trademarks and trade names, customer relationships, assembled work force).

In 2007, the US Financial Accounting Standards Board issued new M&A accounting standards intended to align US Generally Accepted Accounting Principles (GAAP) with the International Financing Reporting Standards (IFRS); these standards took effect in fiscal year 2009 for calendar year-end companies. The new standards impose more stringent criteria for determining the 'fair values' of assets and liabilities as of the acquisition date. Other key changes include new requirements in accounting for certain acquisition costs, contingent liabilities, contingent consideration such as 'earn-outs', in-process R&D and negative goodwill.

17 Target companies and industries

What types of companies or industries have typically been the targets of going-private transactions? Has there been any change in focus in recent years? Do industry-specific regulatory schemes limit the potential targets of private equity firms?

Private equity sponsors target companies as attractive acquisition candidates based on a variety of factors, including steady cash flow, strong asset base to serve as loan collateral or as the subject of future dispositions, strong management team, potential for expense reduction, undervalued equity and limited ongoing working capital requirements. Historically, typical targets have included manufacturing or production-based companies. In the past several years, private equity sponsors have been looking toward targets in the financial, media, telecom, real estate, energy, health care, retail and technology industries. In addition, certain private equity funds have a specified investment focus with respect to certain industries (eg, retail, energy) or types of investments (eg, distressed debt).

Many regulated industries (eg, financial, media, telecoms, energy, banking, transportation, insurance, gaming) must comply with special business combination legislation particular to those industries. Typically, approval of the relevant federal or state governing-agency is required before transactions in these industries may be completed. In certain situations, regulators may be especially concerned about the capitalisation and creditworthiness of the resulting business and the long- and short-term objectives of private equity owners. In addition, as a result of the extensive information requirements of many US regulatory bodies, significant personal and business financial information is often required to be submitted by the private equity sponsor and its executives. Furthermore, in certain industries in which non-US investments are restricted (eg, media, transportation), private equity sponsors may need to conduct an analysis of the non-US investors in their funds to determine whether specific look-through or other rules may result in the sponsor investment being deemed to be an investment by a non-US person. While none of these factors necessarily preclude private equity companies from entering into transactions with regulated entities, all of these factors increase the complexity of the

Update and trends

As was the case in 2009, conditionality and financing risk remained the key issues in private equity transactions in 2010. There did not appear to be a uniform approach to addressing these issues in acquisition agreements and financing documentation. However, certain trends were notable, including:

- the continued use of a reverse termination fee structure, frequently with a higher fee than the standard termination fee payable by the seller;
- granting the seller a limited ability to specifically enforce the transaction against the private equity buyer under specified circumstances such as those described in question 20;
- the increased participation of lenders and their counsel in negotiating terms contained in acquisition agreements, including seeking to add provisions that cap lender liability and require all lawsuits brought against the lenders to be brought exclusively in specified courts; and
- conforming the exclusive jurisdiction provision in acquisition agreements to the corresponding provision in the debt-financing commitments.

In light of the continuing issues surrounding conditionality and financing risk, certain US private equity sponsors have begun to require their financing documentation to be at a more advanced stage of negotiation at the time of signing a definitive acquisition agreement as compared to historical practice in US LBO transactions. Such requirements have included designating a 'form' credit agreement (typically a sponsor or target company precedent financing agreement) to form the basis for negotiating the definitive financing documentation prior to closing and detailing agreed-upon financial or other covenants in commitment letters and term sheets. Private equity sponsors have also continued to require that there is no gap between the conditions to the funding of third-party debt financing and the sponsor's conditions to closing the acquisition.

In addition, there appeared to be an increased willingness of private equity sponsors to structure LBOs as two-step tender offer transactions. In the event the tender offer was terminated (eg, an insufficient number of shares were tendered to enable the buyer to commence a short-form merger without shareholder approval), these transactions typically provided that they would automatically convert into a traditional one-step merger transaction. Presumably, the complexity of structuring these transactions as two-step tender offers (which includes issues surrounding the funding of third-party debt financing prior to the closing of the tender offer and complying with certain statutory safe harbour provisions when entering into new arrangements with existing management) was overcome by the potential benefit of completing the transactions more quickly than traditional one-step merger transactions.

transaction and need to be taken into account by any private equity sponsor considering making an investment in a regulated entity.

18 Cross-border transactions

What are the issues unique to structuring and financing a cross-border going-private or private equity transaction?

The structure of a cross-border private equity transaction is frequently quite complicated, particularly given the use of leverage in most transactions, the typical pass-through tax status of a private equity fund and the existence of US tax-exempt and non-US investors in a private equity fund. Many non-US jurisdictions have minimum capitalisation requirements and financial assistance restrictions (which restrict the ability of a target company and its subsidiaries to 'upstream' security interests in their assets to acquisition financing providers), each of which limits a private equity sponsor's ability to use debt or special purpose vehicles in structuring a transaction. As noted in question 17, non-US investors may be restricted from making investments in certain regulated industries, and similarly, many non-US jurisdictions prohibit or restrict the level of investment by US or other foreign persons in specified industries or may require regulatory approvals in connection with acquisitions, dispositions or other changes to investments by foreign persons. In addition, if a private equity sponsor seeks to make an investment in a non-US company, local law or stock exchange restrictions may impede the sponsor's ability to obtain voting, board representation or dividend rights in connection with its investment or effectively exercise pre-emptive rights, implement capital raises or obtain additional financing.

Furthermore, in a cross-border transaction, the sponsor must determine the impact of local taxes, withholding taxes on dividends, distributions and interest payments and restrictions on its ability to repatriate earnings. Private equity sponsors must also analyse whether a particular target company or investment vehicle may be deemed to be a controlled foreign corporation or passive foreign investment company, both of which can give rise to adverse US tax consequences for investors in the private equity fund. Any of these issues may result in tax inefficiencies for investors or the violation of various covenants in a private equity fund's underlying documents that are for the benefit of its US tax-exempt or non-US investors.

19 Club and group deals

What are the special considerations when more than one private equity firm (or one or more private equity firms and a strategic partner) is participating in a club or group deal?

Private equity sponsors may form a consortium or 'club' to pursue an acquisition for a variety of reasons, including risk-sharing and the ability to pursue a larger acquisition, since most fund partnership agreements limit the amount a fund may invest in a single portfolio company. In addition, private equity sponsors may form a consortium that includes one or more strategic partners. An initial consideration to be addressed in a club deal is the need for the confidentiality agreements negotiated with the seller to allow each participant to share information regarding the target company with the other members of the consortium. The confidentiality agreements may include language permitting each participant to share information with co-investors generally, may specifically identify each member of the consortium or may restrict a participant from approaching any potential co-investors (at least during an initial stage of a sale process) without obtaining the target company's prior consent. The confidentiality agreements may also provide for an allocation of responsibility for any breach of the confidentiality agreements by a member of the consortium or such member's representatives and agents.

Counsel to a consortium must ensure that the consortium agrees upon the proposed price and other material terms of the acquisition before any documentation is submitted to, or agreed with, the seller. In addition, counsel to a consortium will be required to ensure that the terms of any proposed financing, the obligations of each participant in connection with obtaining the financing and the conditions to each participant's obligation to fund its equity commitment have been agreed by each member of the consortium. It is not uncommon for the members of a consortium to enter into an 'interim investors agreement' at the time of signing a definitive purchase agreement or submission of a binding bid letter that governs how the consortium will handle decisions and issues related to the seller and the acquisition that may arise following signing and prior to closing. An interim investors agreement may also set forth the key terms of a shareholders' agreement to be entered into by the consortium members related to post-closing governance and other matters with respect to the acquisition.

Each member of the consortium may have different investment horizons (particularly if a consortium includes one or more private equity sponsors and a strategic partner), targeted rates of return, tax or US Employee Retirement Income Security Act issues and structuring needs that must be addressed in a shareholders' agreement or other ancillary documentation relating to governance of the target company and the future exit of each participant from the transaction. Particularly in the case where a private equity sponsor is partnering with a strategic buyer, the sponsor may seek to obtain certain commitments from the strategic buyer (eg, non-competition covenants, no dispositions prior to an exit by the sponsor) and the strategic buyer may seek to limit the veto rights or liquidity rights (or both) of a sponsor. As discussed in question 13, a shareholders' agreement would typically provide the consortium members with rights to designate directors, approval rights and veto rights and may include provisions relating to pre-emptive rights, tag-along and drag-along rights, transfer restrictions, future capital contributions, put rights, mandatory redemption provisions and restrictive covenants that limit the ability of each consortium member to engage in certain types of transactions outside the target company. The various rights included in a shareholders' agreement are frequently allocated among consortium members on the basis of each member's percentage ownership of the target company following the consummation of the acquisition.

20 Issues related to certainty of closing

What are the key issues that arise between a seller and a private equity buyer related to certainty of closing? How are these issues typically resolved?

Sellers generally seek to obtain as much certainty to closing as possible, which includes limited conditions to the buyer's obligation to close the transaction and the ability to specifically enforce the obligation to close a transaction against the buyer. In private equity transactions without a financing condition, many private equity sponsors have made efforts to ensure that the conditions to their obligation to consummate the acquisition pursuant to the purchase agreement are substantially the same as the conditions of the lenders to fund third-party debt financing to the private equity sponsor's shell acquisition vehicle or otherwise fully within the private equity sponsor's control. In this regard, there have been some transactions in recent years in which the purchase agreement included certain financial performance or other specific conditions related to the target company (eg, minimum amount of EBITDA, minimum credit rating or cash position, maximum debt to EBITDA ratio) that correspond to specific conditions contained in the third-party debt financing commitments.

Private equity sponsors have typically resisted a specific performance remedy of the seller in acquisition agreements. Private equity sponsors often use third-party debt financing in acquisitions and do not want to be placed in position in which the private equity sponsor is obligated to close a transaction when such third-party debt financing is unavailable and the ability to obtain alternative financing is uncertain. In addition to the fact that the transaction would likely no longer be consistent with the private equity sponsor's financial modelling for the transaction in the absence of such debt financing (ie, the transaction would be unlikely to generate the private equity sponsor's target internal rate of return), private equity sponsors are limited in the size of the investments they are permitted to make pursuant to their partnership agreements and therefore may not be able to purchase the entire business with an all-equity investment (as discussed in question 14). As a result, private equity sponsors typically negotiate a financing condition or the ability to terminate the purchase agreement and pay a reverse termination fee to the seller in the event that all of the other conditions to the closing had been satisfied and the private equity sponsor was unable to obtain the financing necessary to consummate the closing (as described in question 11).

In recent years, in addition to negotiating the right to terminate the purchase agreement and pay a reverse termination fee to the seller, some private equity sponsors have agreed to a limited specific performance remedy in which, solely under specified circumstances, sellers have the right to cause the shell acquisition vehicle to obtain the equity proceeds from the private equity fund and consummate the transaction. In the relatively few instances in which such a limited specific performance right has been agreed, such right will arise solely in circumstances where:

- the closing has not occurred by the time it is so required by the purchase agreement (which is typically upon the expiration of the marketing period for the buyer's third-party debt financing);
- all of the conditions to closing have been satisfied (or will be satisfied at the closing);
- the debt financing has been funded (or will be funded if the equity financing from the private equity sponsor will be funded); and, in some cases
- the seller irrevocably confirms that, if specific performance is granted and the equity and debt financing is funded, then the closing will occur.

In addition, some private equity sponsors agreed to give the seller the right to specifically enforce specified covenants in the purchase agreement against the private equity sponsor's shell acquisition vehicle (eg, using specified efforts to obtain the debt financing, complying with the confidentiality provisions, paying buyer expenses).

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