
THE PRIVATE EQUITY REVIEW

THIRD EDITION

EDITOR
STEPHEN L RITCHIE

LAW BUSINESS RESEARCH

THE PRIVATE EQUITY REVIEW

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THE PRIVATE EQUITY REVIEW

Third Edition

Editor
STEPHEN L RITCHIE

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CONTENTS

Editor's Prefacevii
	<i>Stephen L Ritchie</i>
PART I	FUNDRAISING..... 1–196
Chapter 1	BRAZIL.....3
	<i>Sergio Ros Brasil, Marcus Vinicius Bitencourt, Leonardo Homsy and Rodrigo Pires Mattos</i>
Chapter 2	CANADA.....14
	<i>Jonathan McCullough, James Beeby and Isaac Filaté</i>
Chapter 3	CAYMAN ISLANDS24
	<i>Nicholas Butcher and Iain McMurdo</i>
Chapter 4	CHINA.....35
	<i>James Yong Wang</i>
Chapter 5	GERMANY.....46
	<i>Felix von der Planitz, Christoph Keil and Sandra Horst</i>
Chapter 6	INDIA.....60
	<i>Siddharth Shah and Bijal Ajinkya</i>
Chapter 7	JAPAN.....73
	<i>Kei Ito, Taku Ishizu and Akihiro Shimoda</i>
Chapter 8	KOREA.....84
	<i>Young Jay Ro, Young Man Huh, Yong Seung Sun, Joon Ho Lee and Kyle Park</i>

Chapter 9	LUXEMBOURG92 <i>Marc Meyers</i>
Chapter 10	NORWAY 104 <i>Klaus Henrik Wiese-Hansen and Stig Nordal</i>
Chapter 11	PORTUGAL 115 <i>André Luiz Gomes and Catarina Correia da Silva</i>
Chapter 12	SINGAPORE 125 <i>Low Kah Keong and Felicia Marie Ng</i>
Chapter 13	SOUTH AFRICA 135 <i>Johan Loubser, Jan Viviers and Andrea Minnaar</i>
Chapter 14	TURKEY 149 <i>Ümit Hergüner, Mert Oğuzülgen and Zeynep Tor</i>
Chapter 15	UNITED KINGDOM 161 <i>Mark Mifsud</i>
Chapter 16	UNITED STATES 174 <i>Joseph A Smith and Conrad Axelrod</i>
PART II	INVESTING 197–519
Chapter 1	AUSTRALIA 199 <i>Philip Kapp and James Delesclefs</i>
Chapter 2	BELGIUM 211 <i>Stefaan Deckmyn and Wim Vande Velde</i>
Chapter 3	BRAZIL 225 <i>Sergio Ros Brasil, Marcus Vinicius Bitencourt and Camila Caetano Cardoso</i>

Chapter 4	CANADA.....	235
	<i>Brian M Pukier and Sean Vanderpol</i>	
Chapter 5	CHILE	246
	<i>Andrés C Mena, Salvador Valdés and Francisco Guzmán</i>	
Chapter 6	CHINA.....	257
	<i>David Patrick Eich, Pierre-Luc Arsenault, Stephanie Tang and Jesse Sheley</i>	
Chapter 7	FINLAND.....	275
	<i>Mika Ståhlberg, Marcus Möller and Leif Laitinen</i>	
Chapter 8	FRANCE.....	285
	<i>Maud Manon, Xavier Norlain, Jeremy Scemama and Guillaume Valois</i>	
Chapter 9	GERMANY.....	298
	<i>Hans-Jörg Ziegenhain and Alexander G Rang</i>	
Chapter 10	GREECE.....	310
	<i>Christos Gramatidis</i>	
Chapter 11	INDIA.....	318
	<i>Vijay Sambamurthi</i>	
Chapter 12	IRELAND.....	330
	<i>David Widger</i>	
Chapter 13	ITALY.....	344
	<i>Fabio Labruna</i>	
Chapter 14	JAPAN.....	353
	<i>Kei Ito, Taku Ishizu and Tomokazu Hayashi</i>	

Chapter 15	KOREA.....	363
	<i>Young Jay Ro, Jong Koo Park, Yun Goo Kwon, Sung Uk Park and Yun Bak Chung</i>	
Chapter 16	MEXICO.....	373
	<i>Carlos del Rio, Eduardo González and Jorge Montaña</i>	
Chapter 17	NIGERIA.....	388
	<i>Folasade Olusanya, Adekunle Soyibo and Oluwaseye Ayinla</i>	
Chapter 18	NORWAY.....	396
	<i>Peter Hammerich and Markus Heistad</i>	
Chapter 19	PORTUGAL.....	406
	<i>Tomás Pessanha and Manuel Liberal Jerónimo</i>	
Chapter 20	SINGAPORE.....	420
	<i>Andrew Ang, Christy Lim and Dawn Law</i>	
Chapter 21	SPAIN.....	432
	<i>Christian Hoedl and Diana Linage</i>	
Chapter 22	SWITZERLAND.....	444
	<i>David Ledermann, Olivier Stabler and Nicolas Béguin</i>	
Chapter 23	TURKEY.....	457
	<i>Ümit Hergüner, Mert Oğuzülgen and Zeynep Tor</i>	
Chapter 24	UNITED KINGDOM.....	470
	<i>Stephen Drewitt</i>	
Chapter 25	UNITED STATES.....	487
	<i>Norbert B Knapke II</i>	
Appendix 1	ABOUT THE AUTHORS.....	503
Appendix 2	CONTRIBUTING LAW FIRMS' CONTACT DETAILS..	531

EDITOR'S PREFACE

This third edition of *The Private Equity Review* comes on the heels of a very good 2013 for private equity. Large, global private equity houses are now finding opportunities to deploy capital not only in North America and western Europe, where the industry was born, but also in developing and emerging markets in Asia, South America, the Middle East and Africa. At the same time, these global powerhouses face competition in local markets from home-grown private equity firms, many of whose principals learned the business working for those industry leaders.

As the industry becomes more geographically diverse, private equity professionals need guidance from local practitioners about how to raise money and close deals in multiple jurisdictions. This review has been prepared with that need in mind. It contains contributions from leading private equity practitioners in 28 different countries, with observations and advice on private equity dealmaking and fundraising in their respective jurisdictions.

As private equity has grown, it has also faced increasing regulatory scrutiny throughout the world. Adding to the complexity, regulation of private equity is not uniform from country to country. As a result, the following chapters also include a brief discussion of these various regulatory regimes.

While no one can predict exactly how private equity will fare in 2014, one can confidently say that it will continue to play an important role in the global economy. Private equity by its very nature continually seeks out new, profitable investment opportunities, so its continued expansion into growing emerging markets appears inevitable. We will see how local markets and policymakers respond.

I want to thank everyone who contributed their time and labour to making this third edition of *The Private Equity Review* possible. Each of them is a leader in his or her respective market, so I appreciate that they have taken their valuable and scarce time to share their expertise.

Stephen L Ritchie
Kirkland & Ellis LLP
Chicago, Illinois
March 2014

Chapter 5

CHILE

*Andrés C Mena, Salvador Valdés and Francisco Guzmán*¹

I OVERVIEW

Chile continues to offer an attractive business environment. Chile was the first Latin American economy to join the Organisation for Economic Co-operation and Development, and is party to dozens of free trade agreements (including with the United States, the European Union, Mexico, South Korea and Brazil). In terms of competitiveness in Latin America, according to the ranking published by the Latin American Private Equity & Venture Capital Association (LAVCA),² Chile has remained the country with the best overall conditions for the private equity industry for eight years in a row. Also, according to Ernst & Young's annual ranking, Chile leads Latin America as the most attractive market for private equity and venture capital.³ As a result, private equity in Chile has grown significantly: as of the end of 2012, there were approximately 37 investment funds with an estimated amount of investments of US\$600 million, and 24 management firms. Seventeen of these funds are private equity funds with investments of about US\$342.6 million, and 20 funds correspond to venture capital funds with investments of about US\$256.8 million.⁴

i Deal activity

The private equity industry has grown aggressively as a result of changes in the statutory corporate, capital markets and tax framework implemented since 2000. According to

1 Andrés C Mena is a partner at Kirkland & Ellis LLP. Salvador Valdés is a partner and Francisco Guzmán is a senior associate at Carey.

2 LAVCA Scorecard 2013.

3 *Diario Financiero*, 12 December 2013.

4 See Chilean Association of Investment Funds Administrators (ACAFI), 'Venture Capital and Private Equity in Chile' (2012).

the LAVCA Scorecard 2013, investors value the overall environment of institutional and legal certainty, the protection of intellectual property rights, the transparency of the judiciary and the protection of minority shareholders' rights. The adoption this year of the international financial reporting standards for all non-publicly traded companies has also helped maintaining Chile as a regional leader for investing. In addition, Standard & Poor's raised Chile's credit rating in 2012 from A+ to AA-. With this upgrade, Chile became the country with the best credit rating in Latin America and was ranked 23rd worldwide (comparable to Japan, Estonia and Taiwan).

Still, the private equity industry is in an early stage, which makes it particularly attractive for new investors. Unlike other countries (such as Brazil) the number of sponsors in the market is still limited and new players are attracted by the opportunity for better value.

The bigger players (i.e., funds with assets over US\$100 million and with a regional and not purely national focus) are managed both by foreign entities (such as Advent or CVC) and by some regional players (such as Linzor Capital Partners or Southern Cross Group). Other key sponsors in the country are Blackstone, Quilvest, Brookfield, KKR and Partners Group. These funds use local feeder funds to raise capital, mainly from institutional investors. Other key local players include Aurus, Celfin (recently merged with BTG Pactual), Larraín Vial, Independencia, IM Trust and Moneda Asset Management.

The size of most funds (private equity and venture capital) is between US\$15 million and US\$40 million.⁵ This is in line with the trend of Latin America, as according to LAVCA, since 2012 the market shifted towards smaller funds and mid-sized deals.⁶

Typically, foreign sponsors enter the country associated with local firms that have a better understanding of the local market.

Both the number of new deals and their aggregate amount increased considerably during 2012. There were a total of 14 reported deals in Chile during 2012 for an aggregate amount of US\$398 million, an overall increase as compared to 2011, when there were 11 deals for an aggregate amount of US\$42 million (at least according to publicly reported deals; anecdotal evidence suggests that the number and volume of actual new transactions, as opposed to only reported ones, was considerably higher). Exits, however, decreased compared to the previous year, with three exits consummated for an aggregate amount of US\$139 million (as compared to five exits in 2011 for US\$892million).

The table below shows reported deals in Chile during 2012 compared with deals in either countries in the region:

Country breakdowns	2012 investments				2012 v. 2011 growth (%)	
	Amounts		Distributions			
Country	No. of deals	US\$ deals (millions)	No. of deals	US\$ deals	No. of deals	US\$ deals
Argentina	7	18	3%	0%	-36%	-73%
Brazil	147	5,657	62%	72%	63%	36%

5 Ibid.

6 2012 and 2013 LAVCA Mid-Year Reports.

Country breakdowns	2012 investments				2012 v. 2011 growth (%)	
	Amounts		Distributions			
Country	No. of deals	US\$ deals (millions)	No. of deals	US\$ deals	No. of deals	US\$ deals
Chile	14	398	6%	5%	27%	859%
Colombia	14	413	6%	5%	-7%	-34%
Mexico	21	684	9%	9%	-5%	49%
Peru	12	269	5%	3%	500%	-287%
Other	22	437	9%	6%	0%	-44%
Total	237	7,875	100%	100%	37%	21%

Source: 2013 LAVCA Industry Data

The table below shows exits in Chile during 2012 compared to those in the other countries of the region. Although no final figures are available for 2013 at the time of writing this chapter, we provide information on specific deals closed in 2013 in Section III, *infra*.

Country breakdowns	2012 exits				2012 v. 2011 growth (%)	
	Amounts		Distributions			
Country	No. exits	\$ exits (in millions)	No. exits	\$ exits	No. exits	\$ exits
Argentina	1	N/A	2%	N/A	-80%	N/A
Brazil	26	3,529	59%	92%	37%	-38%
Chile	3	139	7%	4%	-40%	-84%
Colombia	4	50	9%	1%	-50%	-94%
Mexico	5	37	11%	1%	67%	N/A
Peru	3	69	7%	2%	-25%	-87%
Other	2	3	5%	0%	-78%	-100%
Total	44	9,826	100%	100%	-17%	-64%

Source: 2013 LAVCA Industry Data

ii Operation of the market

The terms of private equity deals are fairly consistent with industry standards. Frequently, transaction documents are based on US forms (including contracts drafted in English if one of the parties is a non-domestic party). Usual terms include representations and warranties, purchase price adjustments, anti-dilution provisions (including full ratchets), affirmative and negative covenants, events of default, indemnities and non-compete clauses. Shareholders' agreements are generally used for the corporate governance of the target company and to restrict the transfer of shares for the benefit of the private equity sponsor.

In some cases, the private equity seller may agree to escrow arrangements to secure buyer claims until the lapse of the statute of limitations (generally five years). Arbitration is the preferred dispute resolution mechanism for these transactions in almost all instances.

A typical sale process starts with the negotiation by the parties of the basic terms and conditions of the transaction, typically in the form of a term sheet. Term sheets may

include indicative offers subject to due diligence conditionality. Often, the buyer will conduct the due diligence before the announcement of the transaction to the market, but a fair number of deals are announced without any due diligence having been carried out. Diligence ‘outs’ remain the norm, but it is standard practice for sellers to impose minimum thresholds and objective tests. Definitive purchase agreements will still be subject to conditionality, especially as they are relevant to governmental authorisations. For instance, in concentrated markets the approval of the antitrust authority will be a likely requirement, and transactions in the utilities sector will also require approval by the relevant authority (the sanitary authority in the water industry, the energy authority in the electric industry, etc.). If the sale process involves an IPO, prior approval by the Securities and Insurance Commission (SVS) will be required.

Unless there is an IPO, a deal will typically take between three and six months to close (of course, depending on the negotiations of the parties and the complexities of the deal, a particular transaction may take longer or shorter to close).

The management of portfolio companies usually have a significant portion of their compensation tied to stock options and other rewards linked to the performance of the company. Alignment of incentives and favourable tax treatment make this type of compensation very desirable in Chile.

II LEGAL FRAMEWORK

Chile allows for a number of corporate entities with different results in terms of control.

A Chilean corporation is managed by a board of directors, with certain specified decisions reserved to the shareholders.

A corporation can be publicly traded, or ‘open’, private or ‘closed’. An open corporation is one that has issued equity shares registered with the SVS. Registration is voluntary, except where the corporation has 500 or more shareholders, or if at least 10 per cent of its capital stock is held by at least 100 shareholders. Open corporations are supervised by the SVS. All other corporations are closed. Closed corporations are not subject to the supervision of the SVS unless they are issuers of publicly traded securities (whether equity or debt) or if otherwise required by a special regulatory frame (for example, insurance companies).

Corporations are managed and controlled by a board of directors appointed by the shareholders. The board has the broadest authority over the corporation and its affairs. Closed corporations must have at least three board members, open corporations at least five.⁷

There are statutory withdrawal rights for shareholders pursuant to which a shareholder can put its shares to the corporation upon certain actions being approved.⁸

7 An open corporation with a market capitalisation over a certain threshold (currently about US\$50 million) must have at least seven board members.

8 Actions such as the conversion of the corporation into a different corporate type (LLC, SpA, etc.), a division or a merger of the corporation, a sale of substantially all of the assets of the corporation, the granting of guarantees or liens with respect to third-party obligations, *inter*

Corporations in Chile require at least two shareholders.

Chilean law also provides for a corporate type similar to Delaware's limited liability company, with two critical distinctions: Chilean limited liability companies (LLCs) require a minimum of two members, and Chilean LLCs require unanimous consent to amend their charter in any respect, accept new members or to allow existing members to assign their interest.

Share companies (SpAs) combine the best attributes of a corporation (free assignability of the equity interests) with the contractual flexibility of an LLC (the SpA does not require unanimous consent for amendments of its charter). An SpA can be formed by one or more persons (individuals or legal entities), and allows for any type of corporate agreement save for a few mandatory rules.

SpAs allow for a single equity holder and can have as many equity holders as desired. If an SpA, however, reaches the number of equity holders that would render a corporation an open corporation, then it will automatically become an open corporation.

If provided for in their charter, SpAs are allowed to make capital calls and issue equity interests if resolved by management (i.e., without the consent of the equity holders). Unlike corporations, there are no statutory pre-emptive rights (again, except as contemplated by the organisational documents). The organisational documents may indicate minimum or maximum percentages or amounts of capital that are to be directly or indirectly controlled by one or more shareholders. The repurchase of their own equity interests is allowed for SpAs. Contrast this with corporations, which can make capital calls only if agreed by the shareholders. Statutory pre-emptive rights apply to equity issuances by a corporation. Corporations are also generally prohibited from acquiring their own shares and must distribute minimum statutory dividends (at an amount of 30 per cent of net earnings).

However, most notably an SpA may issue preferred shares accruing fixed or variable dividends. Features like preferred dividends accruing from specific businesses or assets are permitted.

Chile also has investments funds. These can be structured as public funds (which are subject to substantive regulations by the SVS restricting the type and amount of assets in their portfolios, transactions with affiliates and periodic reporting to the market) or private funds (which are not subject to such regulations). Only public funds can publicly offer their securities.

i Sponsors' controlling investment of an entity

A sponsor seeking control of an investment in Chile will have to consider the specific features of each type of corporation.

Where the sponsor wishes to acquire control of a corporation, it will require at least the control of the number of shares required to control the board of directors and corporate decisions in shareholders' meetings, typically a majority of the outstanding shares. A number of material corporate actions require approval by at least two-thirds of

alia, result in statutory withdrawal rights. A corporation's charter may provide for additional withdrawal rights.

the outstanding shares.⁹ Some of those actions (such as the sale of more than 50 per cent of the assets and the creation of preferred shares) are material to private equity or venture capital sponsors. No corporate actions require unanimous consent of the shareholders.

Chilean law explicitly recognises shareholders' agreements and provides that they need to be 'deposited' with the corporation as a condition of the parties to it making claims against third parties based on such agreements. Chilean law, however, provides that shareholders' agreements are not enforceable against open corporations insofar as they create restrictions on the transfer of shares.¹⁰ As a result, frequently liquidated damages clauses are agreed to by the parties in amounts large enough to create the appropriate incentives.¹¹

SpAs provide the broadest flexibility in terms of contractual structuring provisions. The express recognition by the statute of contractual requirements in terms of maximum (or minimum) levels of equity interests held by its members, the fairly broad flexibility to trigger increases or reductions in equity capital, the ability to repurchase their shares, *inter alia*, make SpAs highly desirable vehicles for private equity investors.

Uniquely, SpAs' charters can provide for 'squeeze-outs', whereby a minority holder can be forced to sell its interest upon another holder acquiring a certain threshold percentage. SpAs also allow for preferences consisting of multiple vote shares (and shares without voting rights).

In summary, a private equity sponsor will benefit significantly from the flexibility provided by an SpA when setting up a holding vehicle for its investment. By the same token, a sponsor investing in an existing SpA will need to conduct thorough due diligence and understand the implications of the SpA's organisational documents.

ii Structuring considerations for sponsors not domiciled in Chile

The key structuring considerations will be driven by control issues (as previously discussed), tax issues and the regulatory framework relevant to the industry in which the investment is made. For example, a number of activities in Chile have to be – at least directly – performed by corporations (banking, insurance, retirement funds administrators, etc.). In addition, corporations are the only corporate entity that allow for an IPO.

Similar to US tax law, Chilean law creates incentives for the use of leverage in a private equity transaction. Subject to certain conditions, Chilean tax law allows for tax deductions on account of interest payments. The same deduction does not exist for dividend payments.

9 Actions such as the conversion of the corporation into a different corporate type (LLC, SpA, etc.), a division or merger of the corporation, a sale of more than 50 per cent of its assets, a decrease in its equity capital, the valuation of equity contributions made in assets other than cash, the reduction in the number of members of the board of directors, *inter alia*.

10 Section 14 of the Chilean Corporations Act.

11 In general, liquidated damages clauses are enforceable in Chile even if they are considered a 'penalty' or do not bear a direct relation to the expected damages caused by the breach of the relevant obligation.

Ordinarily, dividends remitted to non-Chilean sponsors are subject to a 35 per cent withholding tax rate. Interest payments are taxed at the same 35 per cent rate, but a 4 per cent reduced withholding rate applies, *inter alia*, to interest payments on loans made by foreign banks and financial institutions. In some cases, however, such as when the debt is guaranteed with cash or cash equivalents provided by third parties, in order to qualify for the reduced 4 per cent rate a 3:1 debt-to-equity ratio will have to be satisfied.

When structuring a transaction as a leveraged buyout, sponsors will have to ensure that the *pro forma* amount of debt of the target company (including the debt raised to finance the LBO), allow the surviving company to remain solvent. Chilean bankruptcy courts have jurisdiction to void transactions resulting in insolvent entities.

It is common to bridge a leveraged deal using short-term debt and then to refinance with long-term securities in the bond market.

Another reason for leveraging up a deal is that remittances of equity contributions to a foreign sponsor are first allocated to taxable retained earnings and profits. Accordingly, outflows of capital contributions can only be tax free if the Chilean business does not have accumulated earnings and profits that are taxable. There is no such requirement affecting principal payments on debt transactions.

iii Fiduciary duties and liabilities

The main source of fiduciary duties in the Chilean corporate context is the Corporations Act.¹² Directors of a corporation have an obligation to act with the degree of care and diligence that they would apply in their own affairs. They are jointly and severally liable for damages caused to the corporation or its shareholders for their fraudulent or negligent actions. The same principles apply to an SpA, unless it is not managed by a board of directors.¹³

As a result, a private equity sponsor will not, directly, be exposed to liability with regard to other shareholders. The shareholders of a corporation (or an SpA) do not generally owe fiduciary duties to each other, and are permitted to act in their own self-interest.

Areas of concern for a sponsor arise in the insolvency context. While the Chilean courts do not apply the 'zone of insolvency' test to the same extent that a court in the United States might,¹⁴ the Chilean Bankruptcy Code¹⁵ does provide for liability on account of actions that are fraudulent to creditors. For example, Chilean courts may void a sale of assets consummated within a year of the insolvency of a company.

12 Section 41.

13 Section 424 of the Chilean Commercial Code.

14 Delaware courts have created the 'zone of insolvency' concept, effectively extending fiduciary duties of a board of directors to creditors when a corporation is close to insolvency. See *Credit Lyonnais Bank Nederland, NV v. Pathe Communications Corp.*, 1991 WL 277613 (Del. Ch. 30 December 1991); *Weaver v. Kellogg*, 216 B.R. 563, 582-84 (S.D. Tex. 1997); *Official Comm of Unsecured Creditors of Buckhead America Corp v. Reliance Capital Group, Inc (In re Buckhead Am Corp)*, 178 B.R. 956, 968 (D. Del. 1994).

15 Sections 74 to 81.

They are, however, very unlikely to find liability for a sponsor other than in the very narrow circumstances of a fraudulent voidable transaction expressly provided for in the Bankruptcy Code or under criminal fraud statutes.

Recent experience confirms the liability shield for sponsors. The *La Polar* case has resulted in a large number of claims and litigation (including criminal prosecutions), but none against the private equity sponsor.

La Polar is a large retail company. It was controlled by Southern Cross for a number of years, during which La Polar appears to have, in what seems to have been a common practice, unilaterally (i.e., without the knowledge, let alone the consent, of its clients) changed the terms (including pricing) and conditions of retail loans to its customers. The practice was allegedly on a grand scale, and has resulted in several members of the management team (including the CEO and the CFO) being subject to criminal prosecution. In this situation, litigation has been initiated against the company itself, the management and some individual members of the board. No litigation has been initiated against Southern Cross (the manager of the fund that controlled La Polar) or against any investors in the fund. Several years into the *La Polar* fiasco, the limited liability of the sponsor and the limited partners in a fund is still holding firm in Chile.

III YEAR IN REVIEW

i Recent deal activity

The private equity industry was active during 2013. New players entered into the market and others consolidated their interest in the country with new acquisitions. Among the new sponsors that arrived is Actis, an international firm that focuses its investments in Africa, Asia and Latin America. Actis invested US\$290 million in Aela Energía, Chile's largest wind and solar energy project which is projected to increase the country's renewable energy capacity by 3.6 per cent.

Another representative transaction was the investment of Aurus Bios Investment Fund and Andrómaco Labs in Kinostics, a company formed by Chile's University of the Andes to develop a breakthrough technology for the diagnosis of kidney failure. The intention of the parties is to use this company as a platform for the expansion of this new invention worldwide. In the technology sector, regional investor Kaszek Ventures acquired a stake in the Chilean service comparison startup ComparaOnline.com, a Chilean platform that compares insurance, financial and telecommunication products.¹⁶

ii Financing

From a regulatory standpoint, it is worth noting that Chilean institutional investors, especially pension funds, are a key source of liquidity for private equity in Chile. They can only invest, however, in publicly traded entities, and face significant restrictions if investing in foreign investment vehicles. As a result, international private equity firms generally use local feeder funds to raise capital from institutional investors. Banks are also

16 See also 2012 LAVCA Mid-Year Report.

authorised to participate in private equity deals through their affiliates. Restrictions on the amounts invested (determined as a percentage of their assets) apply.

The Chilean Economic Development Agency (CORFO), the state development agency, is a significant source of financing for private equity and venture capital. CORFO encourages entrepreneurship and innovation by providing resources to start-ups or in key sectors of the economy. CORFO can provide direct financing (up to 40 per cent of the equity of a company) or through lines of credit available to private equity or venture capital investors. CORFO's financing can be unsecured, thereby allowing for additional third-party leverage on a secured basis. By the beginning of 2013, CORFO had committed US\$90 million to venture capital investments, notably exceeding funds invested in the industry last year.

iii Exits

The most important exit during 2012 was the IPO by the construction company Moller y Pérez-Cotapos SA. Private equity investor CVCI divested a majority stake in the company in an offering that raised approximately US\$92 million in the Santiago Stock Exchange. CVCI still holds a minority stake in Moller y Pérez-Cotapos.

IV REGULATORY DEVELOPMENTS

i Regulatory bodies of the industry

Except for specific instances in the context of regulated industries, private equity transactions are generally not subject to special regulations restricting them. If a transaction involves public investment funds or public companies, a private equity sponsor is likely to have to deal with the SVS, which may exercise its overseeing powers. Private investment funds and private companies (including SpAs), on the other hand, are not supervised by the SVS.

For an IPO, both the issuer and its securities to be offered to the public need to be registered with the SVS. An application describing in detail the terms and conditions of the offer is required, and must include extensive information regarding the company (ownership structure, legal information, accounting, business and activities, risk factors, etc.) and its securities. The SVS has ample discretion to approve an application, and usually it will exercise it by asking for further information and for changes to the way information is presented. Once the observations are resolved, the issuer and the shares will be registered in the Securities Registry of the SVS. The SVS making observations is very common; however, an application not ending in an approved registration is extremely unusual.

ii Regulatory developments

Chile is adopting policies to establish itself as the entrepreneurial hub of Latin America.¹⁷ These policies are part of the reform informally referred to as 'MKB', a (somewhat

17 See *The Economist*, 13 October 2012 edition, referring to Chile as 'Chilecon Valley'.

playful) acronym combining the ideas of capital markets reform and the bicentenary of Chile's independence. MKB intends to boost innovation and competition, as well as opening the Chilean financial market internationally. MKB includes reforms on several areas: taxation, consumer protection, the banking system, information and transparency at the governmental level, improvement of government performance, capital markets, access to new markets and improved financing.

As part of these measures, 2012 was declared by the government as the 'year of entrepreneurship' and 2013 as the 'year of innovation'. In addition, and notwithstanding that the cost of starting a business is already one of the lowest of the region,¹⁸ Congress recently approved a statute that permits the incorporation of the different types of legal entities (including closely-held corporations, LLCs and SpAs) essentially for free and within a day. The statute provides an alternative to the required formalities for the incorporation of companies by permitting that the incorporation, modification, conversion, merger, spin-off or dissolution all be effective using an online electronic registry.

In 2013, Congress approved a new statute (the Unified Law on Funds) which transforms Chile into a platform for the management of financial assets across the region. The new regulation sets a common framework and simplifies the legislation on investment funds, mutual funds and investment funds of foreign capital in order to simplify and make their legal and regulatory framework consistent.

The Unified Law of Funds includes tax incentives, such as a tax exemption for foreign nationals investing in funds that hold more than 80 per cent of their assets outside Chile, as well as mechanisms to reimburse value added tax paid by foreign nationals in Chile. The government projects a threefold increase in investment fund activity as a result of the Unified Law of Funds being enacted.

Finally, during 2012 the executive branch enacted regulations in connection with the corporate governance of corporations. The new regulations explicitly state that the directors have not only a right, but also an obligation to inform themselves about the affairs of the corporation. Directors are now under an obligation to affirmatively state and record in the board minutes their opposition to board resolutions in order to be exempt from personal liabilities for damages to the corporation and its shareholders. This should put an end to the practice of remaining silent during deliberations of the board and subsequently claiming opposition to resolutions of the board. The new regulations also make mandatory the appointment of independent experts in the context of the valuations of mergers, including with respect to mergers where the consideration is paid in shares. The new regulations also permit attendance to board and shareholders' meetings by electronic means.

Further developments in the Chilean regulatory landscape have also taken place during 2013 due to regulatory actions and lawsuits by the SVS, which have become known as 'waterfall cases' in reference to the flow of funds between subsidiary companies and shareholders. The waterfall cases are essentially stock sales between affiliates parties that allegedly resulted in losses to minority shareholders (most notably pension funds)

18 See LAVCA Scorecard 2012.

and gains to the controlling shareholders and related investment vehicles. While material regulatory and judicial decisions have yet to be issued, these actions have brought to the regulator's attention the manner in which publicly traded shares are sold, transactions between public issuers and their majority and minority stakeholders, transactions with affiliates, and the role and operations of the securities intermediaries.

V OUTLOOK

Chile has a competitive economy and a well-developed business environment. It has in place a smart regulatory framework with the necessary conditions to attract new investors and the private equity industry in general.

The new policies being implemented to improve the regulatory framework for investors in Chile, the continued growth of Chile's economy, the relatively early stage of the private equity industry in Chile and the number of exits (especially as IPOs) suggest the continued growth of the private equity industry in the country.

Chapter 6

CHINA

David Patrick Eich, Pierre-Luc Arsenault, Stephanie Tang and Jesse Sheley¹

I OVERVIEW

Private equity activity in China in 2012, the latest year for which full-year statistics were available at the time of writing, moderately declined after the surge in 2011, in terms of both investments and exits. According to AVCJ Research, the market research division of the *Asian Venture Capital Journal*, there were 499 private equity investments (of which 262 were publicly disclosed) with an aggregate amount invested of US\$21.1 billion in China during 2012. Compared with 520 investments with an aggregate amount invested of US\$24.6 billion in 2011, the total volume and value of investments in 2012 decreased by 4 per cent and 14.2 per cent, respectively. CVSource, an online database maintained by research and consulting firm ChinaVenture Group, reported that there were 275 disclosed private equity investments in China during 2012 with an aggregate amount invested of US\$19.9 billion, representing a 31.9 per cent and 31.4 per cent decrease, respectively, from 2011. Although different sources use different methodologies to calculate the volume and value of private equity investments, major sources appear unanimous in their assessment that private equity investment activity in China weakened during 2012 compared with 2011.

The distribution among different investment types in 2012 exhibited a pattern largely similar to that of 2011. According to CVSource, growth equity investments, which accounted for 62 per cent of the number of private equity deals and 50 per cent of the total invested amount in China in 2012, remained the dominant type of private equity investment. However, with the capital markets struggling across the region and many

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public Chinese companies suffering from low market valuations, private investments in public enterprises (PIPEs) have also gained notable popularity. Due largely to numerous investments in US- and Hong Kong-listed Chinese companies in 2012, PIPEs accounted for 29 per cent of the number of deals and 39 per cent of the invested amount. Buyouts remained a relatively small portion of private equity investment activity, accounting for 9 per cent of the number of deals and 11 per cent of the invested amount.

Although buyouts remained relatively rare in comparison with deal activity in many other jurisdictions; the trend that began in 2010, emerged in 2011 and grew in 2012 of going-private transactions involving China-based companies, particularly companies listed in the United States, continued in 2013. Of the 66 going-private transactions, including two mergers between public companies and four reverse stock split transactions, which have been announced, signed or closed since 2010, 12 did not proceed (two of which involved private equity sponsors) and 38 have closed (nine in 2011, 13 in 2012, 14 in 2013 and two as of February 2014). As of February 2014, 16 going-private transactions were ongoing, including one announced in 2011, four announced in 2012 and 11 announced in 2013. Of the 38 completed transactions, 16 involved private equity sponsors and of the 16 ongoing transactions, as of February 2014, nine involved private equity sponsors. Of the going-private transactions announced or completed as of February 2014, probably the most notable was the US\$3.7 billion leveraged buyout of Focus Media Holdings Limited, the operator of China's largest lifestyle targeted interactive digital media network, by its management and a consortium of private equity sponsors including The Carlyle Group, FountainVest, CITIC Capital and China Everbright. The deal closed on 23 May 2013, becoming the largest-ever leveraged buyout of a Chinese company. The Focus Media transaction stands out not only by virtue of its size but also the complexity of its financing which involved a syndicate of major international banks and Chinese banks previously unprecedented among Chinese going-private transactions.

II REGULATORY FRAMEWORK

i Acquisition of control and minority interests

China's Companies Law, which became effective on 1 January 2006, sets out the governance framework for the two types of Chinese companies: the company limited by shares (CLS) and the limited liability company (LLC). A Chinese entity in which a non-Chinese investor owns an equity interest is called a foreign-invested enterprise (FIE), of which there are several types, including a wholly foreign-owned enterprise (WFOE), an equity or cooperative joint venture, and a foreign-invested company limited by shares (FICLS). FIEs are subject to separate statutes in addition to the Companies Law, including the Law on Wholly Foreign-Owned Enterprises (which applies to a WFOE), the Law on Sino-Foreign Equity Joint Ventures and the Law on Sino-Foreign Cooperative Joint Ventures (which respectively apply to the two types of joint ventures), and the Interim Provisions on the Establishment of Foreign Invested Companies Limited by Shares (which applies to a FICLS), including their respective implementation rules. The Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (the M&A Rules), jointly issued by six Chinese governmental agencies in 2006 and amended in 2009, establish a general legal framework in which non-Chinese investors

can acquire the equity or assets of a Chinese company. Other statutes and rules govern transfers of equity, mergers and other transactions involving FIEs.²

Government approval regime

An acquisition of or investment in a Chinese company by a non-Chinese investor is subject to a multilayered government approval and registration process. The highest scrutiny is directed at an onshore investment (that is, a direct acquisition of equity in a Chinese company), which requires the approval of the National Development and Reform Commission (NDRC) or its local counterpart and the central Ministry of Commerce (MOFCOM) or, if the size of the transaction falls below US\$300 million, MOFCOM's local counterpart. Approval at the local level typically can be obtained within one month, but approval from the central MOFCOM and the NDRC often takes several months or longer. If a transaction is subject to antitrust or national security review as discussed below, MOFCOM or its local counterpart typically withhold approval until such reviews are cleared.

Whether MOFCOM and the NDRC will grant approval of a transaction depends in part on the Catalogue for the Guidance of Foreign Investment Industries (the Foreign Investment Catalogue), jointly published by MOFCOM and the NDRC, which classifies sectors of the Chinese economy as 'prohibited', 'restricted' or 'encouraged' (with unclassified sectors deemed as 'permitted'). Whereas a non-Chinese investor can acquire full ownership of a company in most 'encouraged' and 'permitted' sectors (and often benefits from special advantages when acquiring a company in an 'encouraged' sector), to invest in most 'restricted' sectors, a non-Chinese party is required to team up with a Chinese partner (and, in some cases, the Chinese partner must maintain a controlling stake). Investments by a non-Chinese party in a 'prohibited' sector are typically prohibited regardless of what percentage of the target is acquired.

In addition to these general approval requirements, foreign investment in several industries, such as construction or telecommunications, is subject to approval from the regulatory authorities governing the applicable industry.

An indirect investment in China by way of an investment in an offshore holding company that owns equity of a Chinese FIE is not subject to the MOFCOM or NDRC approvals applicable to an onshore investment; however, both an onshore and an offshore investment may be subject to China's antitrust and national security review schemes.

Under the Anti-Monopoly Law, which became effective 1 August 2008 (AML), an antitrust filing with MOFCOM is required for any transaction involving a change of control if the individual sales in China in the prior accounting year of each of at least two of the parties involved exceed 400 million renminbi and either the parties' aggregate worldwide sales in the prior accounting year exceed 10 billion renminbi or the parties' aggregate sales in China in the prior accounting year exceed 2 billion renminbi. For the

2 These rules include the Certain Provisions on Change of the Equity Interests of the Investors of A Foreign-Invested Enterprise, the Provisions of the Ministry of Foreign Trade and Economic Cooperation and the State Administration for Industry and Commerce on Merger and Division of Foreign-Invested Enterprises, and the Interim Provisions on Investment Made by Foreign-Invested Enterprises in China.

first 10 months of 2013 (the period for which MOFCOM statistics were available at the time of writing), MOFCOM received 185 merger notifications (14 per cent more than in 2012) and accepted 175 cases (25 per cent more than in 2012). Between January and October 2013, 161 cases were closed. Twenty-one cases (13 per cent) were closed during phase I review and 130 cases (81 per cent) were closed during phase II review. Ten cases (6 per cent) were closed during the extended review period. The average review time in 2013 was 10 days shorter than in 2012. In the 175 cases MOFCOM accepted for review during the relevant period, it imposed conditions on four transactions (compared with six in 2012) and did not permanently block any.

Further adding to the barriers facing a non-Chinese investor in the Chinese market, China's State Council issued Circular 6 in February 2011, which established a national security review scheme for the acquisition of a Chinese business by one or more non-Chinese investors. Two broad transaction types are subject to Circular 6 review: (1) the 'acquisition' of any stake (regardless of the size) in a military enterprise, a supplier to a military enterprise, a company located near sensitive military facilities, or any other company relating to national defence; and (2) the acquisition involving 'control' of a Chinese company whose business involves 'key' agricultural products, energy and resources, infrastructure, transportation services or technologies or manufacturing of equipment and machinery 'affecting national security'.

Both China's antitrust and national security review schemes provide Chinese authorities with wide discretion to determine whether a transaction is subject to review or, if subject to review, whether it should be blocked. Under Circular 6, the meanings of 'key' and 'affecting national security' are undefined. Provisions issued by MOFCOM in 2011 to implement Circular 6 prohibit an investor from circumventing the national security review by structuring a transaction by way of nominee arrangement, trust, overseas investment or other such structures. Under both the AML and Circular 6, 'control' is defined broadly and includes having voting rights sufficient to exercise a major impact on board or shareholder resolutions, particularly with respect to key business or operational decisions. As such, private equity investments involving certain customary protections (for example, veto rights, supermajority voting requirements, negative covenants) arguably could be interpreted to involve 'control' under both statutes. If there is ambiguity as to whether a filing is required, it is usually prudent for an investor to make a filing in order to avoid adverse consequences later. If a transaction is subject to national security or antitrust review, MOFCOM conducts a policy-driven review process to determine whether the transaction can proceed unimpeded: it considers not only the effect of a transaction on national security or competition, as applicable, but also takes into account its effect on the public interest and the stability of the national economy and social order, as well as the views of industry associations and other market participants.

The M&A Rules contain, in effect, a restriction on 'round-trip' investments by requiring approval by MOFCOM of any acquisition of a Chinese company by an offshore company formed or controlled by any Chinese entity or individual affiliated with the Chinese target company. Ordinarily, this approval is not granted. Where the offshore structure was in place prior to the adoption of the M&A Rules in 2006, however, the acquisition of a Chinese target by the offshore entity is still permitted.

Governance of and exit from onshore joint ventures

The Chinese corporate law and regulatory framework applying to FIEs make it difficult for shareholders in a Chinese company to obtain or enforce contractual rights that are considered fundamental for private equity investors in other jurisdictions, including rights pertaining to governance and exit. First, members of an onshore equity joint venture have rights of proportional representation on the board, meaning that a Chinese partner typically has the right to appoint at least one director. Further, certain important corporate acts of any joint venture must be unanimously approved by the board, including: (1) any amendment to the articles of association (which is required in connection with any equity transfer); (2) any liquidation or dissolution; (3) any increase or decrease in registered capital; and (4) any merger or division. As a result, a non-Chinese investor with a majority stake in a joint venture cannot obtain complete control because the minority partner has statutory veto rights via its representative on the board.

Moreover, it may be difficult for a non-Chinese investor to enforce certain exit-related provisions that are often key terms of a private equity investment. Transfers of equity in an onshore joint venture are subject to a statutory consent right and right of first refusal by all other members. Theoretically, such rights can be waived in advance in the joint venture contract. In practice, however, a transfer of a shareholder's interest in a Chinese joint venture requires amendments to the joint venture contract and articles of association as well as the approval of MOFCOM or its local counterpart. Because an amended joint venture contract (which MOFCOM expects to review in order to approve a transfer) requires signatures from all shareholders, the other shareholders' cooperation is necessary in connection with any transfer. The same difficulties arise for a private equity investor seeking to enforce a call right, put right or drag-along right against the Chinese shareholders (a tag-along right is easier to enforce, as the party with the tag right can attempt to block a transfer if the transferor fails to comply with the other shareholders' tag-along right). If the Chinese shareholder is a state-owned enterprise (SOE), enforcement is even more difficult, as a transfer of an SOE's interest in a joint venture is subject to a statutory appraisal and an open bid procedure, unless waived by appropriate authorities. Regardless of what rights may be contained in a joint venture contract, a local Chinese court injunction granting specific performance against a Chinese shareholder and in favour of a foreign investor is far from certain.

Implications of regulatory framework on transaction structure

To avoid seeking NDRC and MOFCOM approval and to enhance structuring flexibility, foreign private equity investors typically prefer to invest in China through an offshore investment. The ideal transaction structure, when feasible, is for the foreign investor to invest alongside a Chinese partner in an offshore Cayman or British Virgin Islands company, with such company owning 100 per cent of a Chinese WFOE (often indirectly through a Hong Kong entity, to obtain preferential treatment on dividends). This structure also allows the foreign investor to benefit from transaction agreements governed by foreign law and to avoid the need to enforce its rights in China. Because of foreign ownership limitations and the prohibition on 'round-trip' investments, however, this offshore structure is seldom available for foreign investments in Chinese targets that have not formed an offshore holding structure prior to the effectiveness of the M&A Rules.

Many non-Chinese investors use a 'variable interest entity' (VIE) structure to invest (indirectly) in China without seeking Chinese regulatory approval. Under a VIE structure, Chinese individuals, often the founders, are the registered shareholders of a domestic operating company, which holds the required licences and permits needed for the business to operate. An investor (often in conjunction with the founders) then forms a WFOE through an offshore entity it owns, and the WFOE enters into a series of contractual arrangements with the operating company and its registered shareholders pursuant to which the WFOE obtains control and an economic interest in such operating company. These contractual arrangements can take many forms, but often include an exclusive service or licence agreement, a voting proxy agreement, share pledge agreement and loan agreement, and an exclusive option agreement (together with a form of equity transfer agreement) allowing the WFOE or its affiliates to acquire the equity interests or assets of the operating company when permitted by Chinese law. Commentators frequently note that the VIE structure is legally risky given that it arguably violates the spirit (if not the letter) of Chinese regulations; however, Chinese companies continue to use this structure.

ii Fiduciary duties and liability

Fiduciary duties of directors, officers and supervisors

The Companies Law is the primary statute regulating the actions and duties of directors, officers and supervisors of a Chinese company. Pursuant to the Companies Law, a director, officer or supervisor must abide by laws, administrative regulations and the articles of association of the company, and has a duty of loyalty and duty of care to the company. As in many other countries, a breach of duty may give rise to civil, administrative or criminal liability. A particular concern to a private equity investor in China, however, is that a director, officer or supervisor may be liable for criminal liability not only for his or her own wrongdoing, but also for crimes committed by the company if he or she is the 'manager directly in charge' or 'person directly responsible' for the management of the matter with respect to which a specific criminal act was committed. This risk of personal liability for company wrongdoing is more acute for a director or officer who is also the chairman of the board, executive director or legal representative of the company or who otherwise serves in a senior management capacity, such as general manager or chief financial officer. Most non-Chinese private equity funds are comfortable appointing their representatives to the boards of Chinese companies notwithstanding the risk of liability, often while seeking to ensure that their representatives are not assigned responsibility for any specific matters. While directors and officers insurance and indemnification agreements may protect against civil liability, many types of administrative or criminal liability cannot be mitigated with insurance and indemnification.

Chinese tax exposure

Since January 2008, China's Enterprise Income Tax Law (EIT Law) has imposed a 10 per cent capital gains tax on the sale of a domestic Chinese company by a foreign investor. Pursuant to the State Administration of Taxation's (SAT's) Circular 698, issued in December 2009, a foreign investor that sells a Chinese company indirectly by selling the equity of an offshore holding company will be subject to this capital gains tax, unless it can demonstrate that the offshore holding company has a commercial justification

other than tax avoidance. Because of the uncertainty in what will satisfy Chinese tax authorities as a non-tax-avoidance justification for using an offshore structure, many practitioners recommend building ‘substance’ in the non-Chinese holding company.

An offshore vehicle established by a non-Chinese private equity investor to make an investment in a Chinese company will be treated as a ‘PRC-resident enterprise’ under the EIT Law and subject to the uniform 25 per cent enterprise income tax on its worldwide income where such offshore vehicle’s *de facto* management body is in China. Although the law is unclear, factors that the State Administration of Taxation may take into account in determining tax residency include whether:

- a* the offshore vehicle locates its senior management and core management departments in charge of daily operations in China;
- b* financial and human resources decisions of the offshore vehicle are subject to determination or approval by individuals or bodies in China;
- c* the offshore vehicle’s major assets, accounting books, company seals, and minutes and files of board and shareholders’ meetings are kept or located in China; and
- d* at least half of the offshore vehicle’s directors or senior management reside in China.

To mitigate the risk that any dividends, sale proceeds or other income received by an offshore vehicle are subject to such tax, an offshore vehicle should take steps to establish that it is not effectively managed and controlled in China.

Bribery statutes

Foreign private equity investors in China also face risks posed by western corruption laws, including the US Foreign Corrupt Practices Act (FCPA) and the UK Bribery Act. Typically, foreign companies that are entirely privately held and do not have US business connections should not themselves be exposed to FCPA jurisdiction; however, if a US fund discovers corrupt practices during the pre-transaction due diligence and permits them to continue post-closing, then that fund would likely be liable for the corrupt conduct that occurred on its watch. This theory of liability was evident in the 2010 prosecution by the US Department of Justice (DoJ) of RAE Systems, in which the DoJ stated that during due diligence on a potential acquisition, RAE learned of ‘improper commissions, kickbacks and “under-table greasing to get deals” by employees’. However, according to the DoJ, RAE ‘chose to implement internal controls only “halfway” so as not to “choke the sales engine and cause a distraction for the sales guys”’. As a result of the enforcement action, RAE paid US\$1.7 million in fines to the DoJ, and disgorged US\$1.25 million to the SEC.

Over the past year, US regulators have displayed an increased focus on firms with Asia operations. According to media reports, JP Morgan has recently come under US government scrutiny for allegedly improper hiring practices in China and Hong Kong. The investment bank is suspected to have hired family members of head executives at state-owned companies in China with the express purpose of winning business and other contracts; the investigation by SEC and DoJ is ongoing. Apparently as a result of the inquiry and attendant publicity, JP Morgan ended IPO discussions with a large Chinese firm and earlier withdrew from underwriting a US\$3 billion listing by China Everbright Bank Co.

In addition to heightened scrutiny from US regulators, foreign private equity investors also face risks posed by foreign corruption laws. Such risks were showcased in recent anti-corruption enforcement actions by regulators in Asia, particularly in the 2013 raid on GlaxoSmithKline (GSK) by Chinese regulators. China's Ministry of Public Security alleged that GSK, through top-level employees, was involved in a widespread corruption scheme that funnelled vast sums in illegal payments to Chinese public officials, hospitals and doctors. Over the course of the investigation the Chinese authorities detained over 40 individuals, and certain GSK employees may even be subject to individual criminal liability. The company is expected to pay a significant fine to Chinese regulators at the conclusion of the investigation.

Given this sort of precedent and the DoJ's increased scrutiny of corruption in Chinese companies in recent years, foreign private equity investors in China have increasingly begun to conduct rigorous anti-corruption due diligence during the pre-transaction period, and then to take steps to ensure that any improper conduct has ceased prior to closing. In many instances, the required steps are fairly limited; however, in high-risk circumstances, such as in transactions involving companies with significant government interactions necessary for operations, the remedial process can be complex and expensive.

III YEAR IN REVIEW

i Recent deal activity

Going-private transactions

The trend of US-listed Chinese companies going private continued in 2013 as sentiment toward such companies remained unfavourable for most of the year because of accounting scandals, shareholder lawsuits and the general market malaise. During 2012, 13 US-listed Chinese companies entered into definitive agreements to go private, up from eight in 2011, and 13 such transactions were closed, up from nine in 2011. During 2013, eight going-private transactions were announced and 14 were closed. As of February 2014, two going-private transactions had been closed in 2014. More US-listed Chinese companies have since either received a going-private offer or formed a special committee of independent directors (and, in many cases, retained financial advisers, legal counsel, or both) to consider their strategic options.

Market research firms and short sellers such as Muddy Waters Research and Citron Research, building on their successes in 2011 and 2012, continued to target Chinese companies listed in the United States in 2013 by issuing critical research reports. Apparently, such firms have often simultaneously taken short positions in the Chinese companies they were covering, sometimes making substantial gains even if their accusations have not always been proven to be correct. Such accusations notably have not been limited to companies that listed through reverse takeovers (RTOs),³ the

3 In an RTO, a private company merges with a publicly traded shell company and, as a result of the merger, the (formerly) private company becomes listed on the NYSE or Nasdaq without having paid the cost or fulfilled the burdensome disclosure requirements of an IPO.

usual suspects in the past. Like similarly consequential criticism by Muddy Waters of Orient Paper Inc in 2010 and Sino-Forest Corp. in 2011, the most notable case in 2012 arose when on 18 July Muddy Waters published on its website a scathing report on the New Oriental Education & Technology Group Inc, sinking the company's share price by 35 per cent in one day. The stock price of New Oriental, apparently one of the more reputable and well-run companies that had undertaken a conventional IPO, subsequently recovered, suggesting that the accusations were not entirely justified. Similarly, on 24 October 2013, Muddy Waters published an 81-page report labelling Beijing-based mobile provider NQ Mobile Inc a 'massive fraud', sending the company's share price tumbling more than 60 per cent in three days. Since then, NQ's share price has also substantially recovered, but as in the New Oriental case, the fact that a single research report inflicted so much damage to a stock strongly suggests a widespread underlying lack of confidence in listed Chinese companies. The depressed valuation of many well-established companies has apparently played a key role in the three-year surge in going-private proposals.

In 2012 the US regulatory agencies also stepped up their efforts to rein in alleged accounting fraud by listed Chinese companies. The SEC requested certain Chinese auditors to turn over audit work papers for investigations of potential wrongdoing by certain US-listed Chinese companies audited by these accounting firms. The auditors, citing Chinese laws prohibiting such disclosure to foreign authorities, refused to comply. On 3 December 2012, the SEC charged five Chinese audit firms, namely the Chinese affiliates of the 'Big Four' and BDO, with violating the US Securities Exchange Act and the Sarbanes-Oxley Act, which requires foreign public accounting firms to provide the SEC upon request with audit work papers involving any company trading on US markets. After administrative proceedings during 2013, on 22 January 2014, SEC Administrative Law Judge Cameron Elliot ordered that the Chinese affiliates of the 'Big Four' accounting firms should be suspended from auditing US-listed companies for six months, triggering significant volatility in the share prices of Chinese companies listed in the US, especially internet and solar stocks, which declined precipitously on 22 and 23 January. On 24 January, the China Securities Regulatory Commission responded, announcing that the decision 'ignored' China's efforts and progress made on cross-border regulatory cooperation, and warning that there could be unspecified 'consequences'.

Market commentators initially expressed grave concerns, including that the Chinese companies whose auditors had been charged would miss filing their 2013 annual reports, which are required to comply with US listing requirements. In theory, the SEC could then delist all of the Chinese companies listed on American exchanges, which would obviously have devastating consequences for such companies, as well as multinationals operating in China, and in each case their advisors and other business partners and potentially damage the capital-raising function of US markets. In practice, however, affected companies expect that it may be many months before the administrative decision is finalised and appeals are concluded. Some commentators have suggested that one solution would be for the SEC to require disclosure that the audit work papers of domestic Chinese auditors may not be made available to the SEC, so that investors can take this information into account in their investment decisions.

In addition to the SEC's enforcement action, the Public Company Accounting Oversight Board (PCAOB)⁴ has been trying to obtain permission from the Chinese regulatory authorities to inspect Chinese audit firms, as part of its effort of conducting international inspection of PCAOB-registered accounting firms which are auditors of US-listed companies. The Chinese regulatory authorities balked at first but negotiations continued and in May 2013 the PCAOB indicated it had reached an agreement with the Chinese authorities to obtain access to audit workpapers in connection with companies being investigated by the SEC. As of February 2014, the PCAOB had not yet been able to obtain an agreement providing the access required for the PCAOB's routine inspections of PCAOB-registered audit firms based in China. In theory, the PCAOB could deregister such firms if it cannot reach an agreement with China to gain inspection rights over them; US-listed Chinese companies would then be without their auditors and may have to be delisted. Jim Doty, the chairman of the PCAOB, stated in a budget and policy hearing before the SEC on 5 February 2014, however, that he expected to achieve such an agreement in 2014, and noted in subsequent remarks to the press that the Chinese and the PCAOB already had been exchanging draft agreements but had not yet decided how the inspections would be conducted.

Despite the 84 per cent decline in such filings from 2011 levels, US investors also continued to bring actions against US-listed Chinese companies in 2013, the frequency of which remained above the average of the 2007–2012 period, according to Cornerstone Research. Cornerstone found that in 2011, 42 class action lawsuits were filed against US-listed Chinese companies, which accounted for 22 per cent of all US federal securities fraud class action filings during this period. In 2012, 18 such class actions were filed, accounting for 12 per cent of all such class actions during the period. In 2013, filings against Chinese companies remained the most prevalent type of foreign filing: 12 such class actions were filed, accounting for 7 per cent of all such class actions during the period.⁵ These actions alleged various securities laws violations, including violations of Section 10(b) and Rule 10b-5 of the US Securities and Exchange Act and Section 11 of the US Securities Act.

As a consequence of continued pressure from the regulatory crackdown, negative press, short-selling activities and shareholder lawsuits, the stock prices of US-listed Chinese companies remained depressed through 2012 and 2013. The low valuations presented potential opportunities for management shareholders and private equity investors to privatise the US-listed companies, often with the aim of relisting them in other markets, for example, on the Chinese or Hong Kong stock exchanges, where the trading multiples for Chinese companies tend to be higher and market research coverage is seen as being more positive and understanding of the Chinese context. Importantly, the going-private trend was not limited to entities resulting from an RTO; nine of the

4 The PCAOB is a non-profit corporation established by the US Congress to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports. The PCAOB also oversees the audits of broker-dealers, including compliance reports filed pursuant to US federal securities laws, to promote investor protection. (<http://pcaobus.org/Pages/default.aspx>.)

5 Cornerstone Research, Securities Class Action Filings, 2013 Year in Review, pp. 18–19.

13 significant Chinese companies that announced a going-private transaction in 2012, for example, were Cayman Islands or British Virgin Islands companies that accessed the public markets through a conventional IPO, compared with four Cayman Islands companies out of eight China-based companies in 2011. Companies that list in the United States through a conventional offering may be appealing targets for a private equity investor given that, although their market valuations may have been materially reduced by the current investor mood disfavouring Chinese companies, they may be less likely to have the same types of accounting or securities law compliance problems as have had companies that became public through an RTO.

The large number of Chinese going-private transactions involving a Cayman-incorporated target may have been driven in part by the introduction of new merger legislation in the Cayman Islands in April 2011, which contributed to making the statutory merger route within the Cayman Islands Companies Law an attractive means of effecting a going-private transaction. The merger process typically requires the buyer group to form a new Cayman Islands company that will merge with, and be subsumed by, the listed Cayman target. Under the 2011 amendments to the Cayman Islands Companies Law, the shareholder threshold for passing a statutory merger was reduced to a special shareholder resolution requiring only two-thirds (instead of 75 per cent) of the shareholders present at the meeting, absent any higher threshold in the articles of association of the target company. The lower merger approval threshold makes it an attractive acquisition option when compared with either a 'squeeze out' following a takeover offer or a scheme of arrangement, which would add time and cost arising from the court driven process.

Of the 13 significant going-private transactions announced during 2012, the acquisition of Focus Media by a consortium consisting of its chairman, The Carlyle Group, FountainVest, CITIC Capital, China Everbright and Fosun International, the second-largest shareholder of the company, was the only one that involved third-party private equity investors acquiring a controlling stake in the target company (in the Focus Media deal, the chairman and Fosun International agreed to exchange a portion of their shares for a stake of approximately 48 per cent in the post-closing company and cash out the remainder of their shares on the same terms as the public shareholders). In the 12 other announced transactions, it was proposed that management would either retain a controlling stake in their company or share control with other investors. In four of these transactions, the founders sought to obtain equity financing from a private equity firm, which would become a minority shareholder of the company after closing: Abax Global Capital, in the case of Fushi Copperweld; SAIF Partners, in the case of China TransInfo; China Wealth Growth Fund, in the case of Zhongpin; and TPG, in the case of ShangPharma.

Most of the transactions that closed in 2012 took between three and four-and-a-half months to close and were structured as a one-step, negotiated merger (as opposed to a two-step transaction consisting of a first-step tender offer followed by a second-step squeeze-out merger, which is the other basic approach to acquiring a US public company). In a one-step merger, a company incorporated in a US state will be subject to the US proxy rules, which require the company to file a proxy statement with the SEC and, once the proxy statement is cleared, to mail the definitive proxy statement to the shareholders and set a date for its shareholders' meeting. Because all of these transactions

involved management retaining (either by themselves or with others) a controlling stake (or, in the case of Focus Media, a substantial minority stake), they were all 'going-private' transactions as defined under Rule 13e-3 of the Securities and Exchange Act, also commonly referred to as '13e-3 transactions'. A 13e-3 transaction requires making additional disclosures to the public shareholders, including as to the buyer's position on the fairness of the transaction. An important implication is that, whereas the SEC reviews only a fraction of all proxy statements, it routinely reviews 13e-3 transactions, which can lengthen the process by several months. Companies incorporated outside the United States that are listed on US stock exchanges (including the recent going-private targets that are incorporated in the Cayman Islands or the British Virgin Islands) are known as foreign private issuers (FPIs). FPIs are not subject to the proxy rules, but they are subject to 13e-3 disclosure obligations and are required to include as an exhibit to their 13e-3 filings most of the information that is required to be disclosed in a proxy statement by a US domestic issuer. Accordingly, both a transaction involving a US domestic company and a 13e-3 transaction involving a FPI follows a comparable timetable for purposes of SEC review.

Three going-private targets out of the closed transactions in 2012 had a VIE structure: China Mass Media Corp, Fushi Copperweld and China TransInfo. None of these transactions went through the MOFCOM antitrust review either because they did not involve a change of control (as the founders had a controlling stake in the company both before and after the transaction) or the parties did not meet the sales thresholds set out in the AML. Since MOFCOM is not known ever to have approved of a transaction that involves a VIE structure, practitioners generally believe that the presence of a VIE structure would be a significant impediment to a private equity investor seeking to acquire a controlling stake in a company if Chinese antitrust clearance is required.

A trend towards consolidation in the internet and technology industry involving US-listed Chinese companies appeared to emerge in 2012. In the online video space, Youku Inc combined with Tudou Holdings Ltd through a stock-for-stock merger, with Youku surviving the merger as a listed company. In the IT outsourcing sector, HiSoft Technology International Limited combined with VanceInfo Technologies Inc. through a stock-for-stock merger with HiSoft surviving the merger as a listed company. Both mergers involved transactions between strategic players in which the founders and the venture capital backers of the targets sold their shares and became holders of the publicly traded shares of the surviving companies. In each of these transactions, the surviving company filed a registration of Form F-4 to register its securities to be issued to the targets' shareholders.

Other notable transactions

Although going-private activity retained the spotlight throughout the year, 2012 also saw a number of successful deals involving privately owned targets. In one of the year's megadeals, a group of private equity firms and sovereign-wealth funds made a US\$3.9 billion investment in Chinese e-commerce giant Alibaba group. The proceeds of the investment, together with debt financing from China Development Bank and a consortium of international banks, were used to support Alibaba's repurchase of a 20 per cent stake in itself from Yahoo! for US\$7.6 billion. The investor group, which included China Investment Corporation, Boyu Capital, CITIC Capital and CDB Capital, as

well as existing investors including Silver Lake, DST Global and Temasek Holdings, subscribed for a combination of common shares and convertible preferred shares in Alibaba.

In addition, TPG Capital's US\$500 million buyout of Shanghai-based cosmetics packaging firm HCP stands out as a rare full acquisition of a family-run business by a private equity firm in a country where entrepreneurs are reluctant to give up control of their companies. As part of the deal, media sources commented that TPG would appoint a new chief executive, but that members of the founding Chen family would remain in key management roles. TPG's buyout was reportedly backed with a US\$300 million five-year loan, making it one of the largest leveraged buyouts ever seen in China.

Also noteworthy is Morgan Stanley Private Equity Asia's US\$300 million investment in Chinese chemicals manufacturer Tianhe Chemicals Group, the country's largest producer of lubricant oil additives and a leading global producer of specialty fluorochemicals. The deal was reported to have been driven by the aim to help Tianhe expand into US and European markets. As part of the transaction, the chief investment officer of Morgan Stanley's Asia arm joined Tianhe's board.

ii Deal terms

Deal terms in going-private transactions

Most of the Chinese going-private transactions identified above have involved all-cash consideration. In 2012, the per-share acquisition price represented an average premium of 43 per cent over the trading price on the day before announcement of receiving the going-private proposal, but an average loss of approximately 30 per cent over the trading price at the beginning of 2010, when the trading price of US-listed Chinese companies was near its peak.

In a 13e-3 transaction, the board of directors of the target typically appoints a special committee of independent directors to evaluate and negotiate the transaction and make a recommendation. If the target is incorporated in the United States, the transaction almost inevitably will be subject to shareholders' lawsuits including for, claims of breach of fiduciary duties, naming the target's directors as defendants. Because the target's independent directors often include US residents, a key driver of a transaction's terms is the concern for mitigating shareholders' litigation risk. While in 2012, no litigation claims for breach of fiduciary duties in a Chinese going-private transaction involving Cayman or British Virgin Islands companies were made public, it remains possible that, as the going-private trend persists, plaintiffs' firms will begin to articulate creative arguments in Cayman mergers and the Cayman courts may look to the body of Delaware law as persuasive precedent for adjudicating claims of breach of fiduciary duties. As a result, whether a going-private transaction involves a US or Cayman-incorporated target, targets typically insist that certain key merger agreement terms (in addition to the deal process) be within the realm of what is 'market' for similar transactions in the United States.

An important negotiated term in many going-private transactions is the required threshold for shareholder approval. Delaware law requires that a merger be approved by shareholders owning a majority of the shares outstanding. Special committees often insist on a higher approval threshold, however, because under Delaware law, the burden of proving that a going-private transaction is 'entirely fair' to the unaffiliated shareholders

shifts from the target directors to the complaining shareholders if the transaction is approved by a majority of the shareholders unaffiliated with the buyer group (i.e., the majority of the minority). In this type of US shareholder litigation, this burden shift is often seen as outcome determinative. Under Cayman law, there is no well-defined benefit for the company to insist on a higher approval threshold than the statutory requirement.

Another key negotiation point is whether the target would benefit from a go-shop period, which is a period following signing of a merger agreement during which the target can actively solicit competing bids from third parties. When defending against a claim of breach of fiduciary duty in Delaware, a company and its directors may point to a go-shop period in a merger agreement as a potentially helpful fact.

Another interesting issue in Chinese going-private transactions is how the parties address the conflict between the company founder's interest as part of the buyer group and his or her influence over the target and its management. A key consideration for the target is obtaining certainty that if, after signing a merger agreement, the founder determines (for any reason) that he or she no longer wishes to consummate the merger, he or she would not exercise influence as head of the company to block or hamper the transaction. To address this conflict, most merger agreements in going-private transactions provide that the target will not be in breach of a representation or warranty if such breach was known by those members of management who are participating in the buyer group and, likewise, the company would not be in breach of a covenant as a result of an action by such members of management. This approach provides the target with comfort that the founder, as a leader of the buyer group, would not be able to terminate the merger agreement as a result of any action or inaction that was within his or her control or any matter known to him or her prior to signing the merger agreement. In the 2012 *Focus Media* transaction, the merger agreement did not include this concept because the chairman participated in, but did not lead, the buyer group.

Deal terms in growth equity investments

Deal terms are more difficult to evaluate and synthesise in private transactions, where terms are not publicly disclosed. Generally, in the context of a growth equity investment (which, as we have seen, remains the dominant type of deal both by number of deals and by aggregate amount invested), private equity investors often continue to expect aggressively pro-buyer terms. This expectation applies whether a transaction involves an onshore Sino-foreign joint venture or an investment offshore alongside a Chinese partner. In a subscription agreement for a growth equity deal, an investor typically benefits from extensive representations and warranties against which the company makes only limited disclosures; in some cases, an investor has knowledge that some representations may not be accurate, but still insists on a representation to facilitate a potential indemnification claim later. It is not uncommon for an investor to also enjoy an indemnity provision with a cap on the amount of losses subject to indemnification as high as the purchase price (or no cap at all), no deductible or threshold and an unlimited survival period. Shareholders' agreements often contain similarly pro-investor terms, such as extensive veto rights (even in the case of a relatively small minority stake) and various types of affirmative covenants binding the company and its Chinese shareholders. If an investment is structured offshore (through, for example, a Cayman company that owns a Chinese subsidiary), a private equity investor may enjoy 'double-dip' economics pursuant to which, in the event

of a liquidation or sale of the company, the investor is entitled to, first, a liquidation preference before any of the Chinese shareholders receive any proceeds, and second, such investor's *pro rata* share of the remaining proceeds based on the number of shares it owns on an as-converted basis. Because there is no well-defined 'market' when it comes to transaction terms in Chinese growth equity deals (unlike in going-private transactions), however, issuers also have opportunities to request, and sometimes obtain, terms that are very favourable to them. In Chinese growth equity investments, the parties' respective leverage and degree of sophistication are more likely to dictate the terms that will apply to a transaction than any market practice or standard.

For a private equity investor with sufficient commercial leverage, the key challenge often lies not in convincing the investee company or its Chinese shareholders to agree to adequate contractual terms, but rather in getting comfort that an enforceable remedy will be available in the event that the Chinese counterparty reneges on its contractual obligations. One potential antidote to the difficult enforcement environment onshore is to seek a means of enforcement offshore. An investor can get comfort if it obtains, for example, a personal guarantee of the Chinese founder backed by assets outside China, governed by New York or Hong Kong law and providing for arbitration in Hong Kong as a dispute resolution venue. Such a guarantee, however, is rarely available (because the Chinese founder may not have assets outside of China) and, even when potentially available, is often unacceptable to the founder. A more realistic alternative is for a private equity investor to seek the right to appoint a trusted nominee in a chief financial officer or similar position (who could monitor an investee company's financial dealings and compliance with its covenants to its shareholders). An investor may also seek co-signatory rights over the target company's bank account, in which case, an independent third party (the bank) will ensure that funds are not released other than for purposes agreed by the investor.

iii Debt finance

Third-party debt financing continues to be available for acquisitions of Chinese companies by private equity investors. One key challenge, however, is that a Chinese target does not generally have the ability to give credit support (by way of guarantee or security over its assets) to a lender of offshore acquisition finance debt.

Many of the going-private transactions of US-listed Chinese companies involved debt financing, with the terms of the financings reflecting varying commercial and structural challenges. The acquisition debt was typically borrowed by an offshore acquisition vehicle with the borrower giving security over its assets (including shares in its offshore subsidiaries) to secure repayment of the debt. As was the case in 2011 and 2012, the typical lenders on these transactions spanned a wide range of financial institutions, from international investment banks to policy banks and offshore arms of other Chinese banks.

The *Focus Media* financing remains the standout transaction among the other debt financed going-private transactions, due mainly to the size and complexity of the debt financing facility and the large consortium of both major international banks (Bank of America Merrill Lynch, Citibank, Credit Suisse, DBS Bank, Deutsche Bank and UBS) and offshore arms of Chinese banks (China Development Bank, China Mingsheng and ICBC) that provided the financing. The *7 Days Inn* financing was another notable

debt financed going-private transaction which was largely financed by a syndicate of Asian banks (Cathay United Bank, China Development Industrial Bank, CTBC Bank, Entie Commercial Bank, Nomura, Ta Chong, Taipei Fubon Commercial Bank, Bank of East Asia and Yuanta Commercial Bank). It can perhaps be considered as a positive signal for any future going-private transactions that such a large number of financiers were comfortable to commit to funding this type of event driven financing. Another emerging theme in these offshore financing structures is that borrowers are seeking to access liquidity from the US debt markets in respect of what are essentially acquisitions of Chinese based businesses – including as a means for a take-out for bridge financing originated out of Asia.

IV REGULATORY DEVELOPMENTS

i Recent measures on capital contributions in the form of equity

On 21 September 2012, MOFCOM issued the Tentative Provisions on Capital Contributions Made in the Form of Equity Involving Foreign-Invested Enterprises, which became effective on 22 October 2012. These provisions delineated the process by which an investor can make a contribution to the registered capital of an FIE in the form of an equity interest in another Chinese company. Such a contribution can be made to incorporate a new FIE, convert a non-FIE company into an FIE or increase the registered capital of an existing FIE. Under these provisions, the equity included in the capital contribution has to be appraised by a licensed Chinese valuation firm and (consistent with existing requirements under the Companies Law) the aggregate value of the non-monetary contributions to a FIE, including equity contributions, cannot exceed 70 per cent of the registered capital. These provisions provide private equity investors with more flexibility in structuring their investments in China.

ii Clarification of beneficial ownership status for tax treaty purposes

Of particular interest to private equity funds that utilise an offshore structure to invest in China is the SAT's Bulletin [2012] No. 30 (Bulletin 30), issued on 29 June 2012, which provided guidance on the determination of beneficial owners for tax treaty purposes. Under pre-existing SAT guidance, in order for a resident of a jurisdiction with which China has entered into a tax treaty (such as Hong Kong or Singapore) to enjoy preferential tax treatment on dividend, interest or royalty income received from China, that resident must be the beneficial owner of that income. Bulletin 30 clarified that the Chinese tax authorities must conduct a comprehensive analysis of all relevant factors specified in existing SAT guidance to determine whether a tax resident seeking treaty benefits is a beneficial owner of the income for treaty purposes, rather than focusing on a subset of factors and excluding other relevant factors. In addition, under this standard, the absence of a purpose to evade or reduce taxes is not a sufficient basis for conferring beneficial ownership status for tax treaty purposes. Perhaps the most positive development of Bulletin 30 is a new safe harbour rule pursuant to which a publicly listed company (and, subject to certain limitations, its wholly-owned subsidiaries) applying for treaty benefits is treated automatically as the beneficial owner of dividends received from a Chinese company.

iii Recent SAFE circulars to regulate conversion of foreign currencies

The SAFE issued two new circulars on 19 November 2012, the Circular on Relevant Issues Regarding Administration of Foreign Exchange for Foreign-Investment Partnership (Circular 58) and the Circular on Further Adjustments to Measures for the Administration of Foreign Exchange for Director Investment (Circular 59). These two measures, which both became effective 17 December 2012, simplified the approval process to convert foreign currencies into renminbi.

Circular 58 provided that the approval procedures relating to a foreign-invested partnership enterprise (FIPE) are in many respects similar those applicable to an FIE under existing SAFE regulations and, among other things, as with an FIE, an FIPE cannot exchange its registered capital into renminbi other than for use consistent with its business scope. Under these new regulations, an FIPE controlled by a private equity sponsor is able to exchange the capital contributed by foreign partners to renminbi for making equity investments in China (if equity investments are included in its business scope).⁶ Circular 59, for its part, abolished a number of approval requirements related to an investment by a foreign invested holding company. Although the changes are more procedural than substantive, they have shortened the time needed for a foreign investor to complete acquisitions in China.

iv Supreme People's Court ruling on value adjustment mechanisms

In its 7 November 2012 judgment in the case of *Haifu v. Shiheng*, the Supreme People's Court of China (the Supreme Court) gave helpful guidance on structuring a value adjustment mechanism in an onshore private equity investment. The case involved an investment contract under which Haifu Investment, a Chinese private equity firm, had acquired a 3.85 per cent equity stake in Gansu Shiheng Nonferrous Resources Recycle Company. Under the investment contract, the company was required to make a cash payment to Haifu Investment based on an agreed formula to the extent the company's net profits for 2008 were less than an agreed threshold, and the company's controlling shareholder undertook to indemnify Haifu Investment if the company fails to perform its obligation. Prior to the case reaching the Supreme Court, the lower courts had held as unenforceable the value adjustment mechanism agreed in the investment contract on the ground that it violates mandatory provisions of applicable Chinese laws. The Supreme Court concurred with the lower courts in part in that it held that the value adjustment mechanism was not enforceable against the company, noting that such an arrangement was tantamount to giving the investor a fixed return for its investment and would adversely affect the company and its creditors. The Supreme Court also reversed in part the lower courts, however, by holding that the undertaking by the controlling shareholder to make the cash payment did not raise the same concerns and was therefore enforceable. Although China's legal regime is based on civil law and the common law doctrine of *stare decisis* therefore does not typically apply, commentators believe that the Supreme Court judgment in practice carries weight with Chinese judges.

6 See 'SAFE relaxes grip on forex controls,' *China Law & Practice*, January–February 2013, p. 22.

V OUTLOOK

The SEC's enforcement action against the China affiliates of five large international accounting firms, and the PCAOB's ongoing efforts to gain inspection rights as regards the Chinese auditors of US-listed companies have added to regulatory uncertainty for US-listed Chinese companies. A failure by US regulators to reach an agreement with China on accounting oversight theoretically could lead to extensive further delisting of Chinese companies from the US market because of the lack of permissible auditors. The SEC and PCAOB do not appear to be pushing for such an outcome, however. The investment community seems to expect the US and Chinese regulators to reach a compromise, as it is carrying on investing in US-listed companies and those that intend to list in the US.

The regulatory overhang may have helped keep the valuation of the Chinese companies listed in the US in check, making some of the more established and well-run companies targets of PIPEs and LBOs. In addition, it is expected that the number of strategic Chinese buyers should increase as the government encourages consolidation across industries and as medium-size companies begin growing more rapidly with a rebound in the economy, which will likely provide exit opportunities for private equity investors.

As the Chinese economy now appears to have rebounded and to be positioned for slower but steady growth after the global financial crisis and uncertainties created by the change in leadership, most observers expect private equity investments, as well as IPOs and other exits, which resumed their growth in the latter part of 2013, to continue growing into 2014.

Chapter 15

UNITED KINGDOM

*Mark Mifsud*¹

I OVERVIEW

After a number of challenging years, 2013 would seem to be the year in which the tides of private equity commenced changing in favour of the beleaguered general partners (GPs)² raising funds as fundraising figures for 2013 are higher than those of any year since 2008.³ Preqin further notes that the average size of Europe-focused vehicles doubled when comparing the US\$309 million average size in 2010 to US\$642 million in 2013. Furthermore, a notable number of Europe-focused funds are reported to have had final closings in 2013 with sizes in excess of US\$1 billion,⁴ and further demonstrating optimism in the market nearly half of the reported 484 Europe-focused funds currently marketing have already held initial closings, raising US\$50 billion.⁵ The substantial increase in distributions received by investors from their private equity holdings in 2013 (globally US\$120 billion in 2013 as opposed to US\$115 billion in 2012) has increased the willingness of investors to reinvest in the asset class.⁶ A number of long-term institutional investors in the asset class have rigid (and in some cases increasing) allocations to private equity and therefore need to continue making commitments to satisfy such target allocations.

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- 1 Mark Mifsud is a partner at Kirkland & Ellis International LLP. The author would like to thank Stephanie Biggs and Jane Scobie for their contributions to this chapter.
 - 2 In this Chapter, 'firm', 'manager' and 'general partners' are used interchangeably and could include reference to GPs, advisers, etc.
 - 3 2014 Preqin Global Private Equity Report.
 - 4 22 funds have been reported by Preqin to have closed in 2013.
 - 5 Preqin.
 - 6 Private Equity News 2 January 2014, Cambridge Associates LLC estimates. See also Bloomberg Brief 2013 Year End Review.

However, any enthusiasm should be qualified. Notwithstanding the encouraging increases in amounts raised from, and returned to, investors in private equity, the separation between the ‘haves’ and ‘have-nots’ mentioned in previous editions has become more exaggerated, as it would appear that notwithstanding a 12 per cent increase in amounts raised from investors, the number of funds closed in 2013 was 19 per cent lower than in 2012.⁷

This leads to an increase in concern about zombie funds as a larger number of funds reach a critical point in their lifespan with GPs who are unable to raise a successor fund and still hold large amounts of assets under management.⁸ Their predicament is exacerbated by a number of other issues such as the Volcker Rule, which adversely affects the ability of some existing investors to ‘re-up’ in existing funds.

Preqin estimates that there are 1,200 funds worldwide that can be called zombies – sitting on US\$116 billion of assets.⁹ This has led to the creation of a separate industry of private equity advisors and funds focusing on this element of the market,¹⁰ with the banner transactions of Behrman Capital and Willis Stein¹¹ leading the way. Other solutions utilised in such situations involved the creation of new ‘spin-out’ firms, managing portions of the assets in beleaguered funds – for example the spin-outs of two new firms, Tailwater Capital LLC and Kainos Capital Fund from HM Capital.¹²

Another counterweight to the reluctance of some investors to invest in private equity has been the growth of Sovereign Wealth funds, which saw their assets increase beyond US\$5 trillion and a greater enthusiasm for investing in private equity.¹³

II LEGAL FRAMEWORK FOR FUNDRAISING

i Jurisdiction and legal form

The key drivers in any fund structure are generally those of limited liability, tax transparency and efficiency, ease of use and flexibility. Notwithstanding the wide range of possible structures that could be utilised, a limited partnership structure is the vehicle of choice for most UK fundraisings.¹⁴ As will be expanded upon further below, the general trend is for the fundraising market to adopt two main strategies in structuring: being located within the UK (thus being subject to the full range of UK tax and regulation, including – for larger firms – the Alternative Investment Fund Managers Directive

7 2014 Preqin Global Private Equity Report.

8 Private Equity Spotlight – June and September 2013.

9 Preqin. Reuters Thursday 13 June 2013.

10 <http://media.visioncapital.com/lib/docs/094432-130912preqinpespotlightdarticle.pdf>.

11 Reported in the 2012 edition of this chapter, but see footnote 12 below for further information.

12 www.pionline.com/article/20130610/PRINT/306109969/end-may-be-near-for-zombie-private-equity-funds.

13 *Private Equity Spotlight* – November and December 2013 – Private Equity Spotlight 2013 in Review.

14 Structures aimed at the retail market, such as VCTs, are not considered herein.

(AIFMD)), or being located offshore (thereby being outside of the UK's (and EU) VAT, tax and regulatory net).¹⁵

Thus the former strategy would generally utilise an onshore limited partnership, usually an English limited partnership (although Scottish or other jurisdictions may be used). The latter strategy would generally involve the use of an offshore-domiciled limited partnership – generally Guernsey or Jersey – although the former seems to be the favoured jurisdiction for offshore private equity funds, with increasing competition from Jersey. Other possibilities include Delaware, the Cayman Islands and Bermuda, but these are very much the exception in a UK fundraising, primarily due to time zone and investor familiarity concerns.

Some investors have preferences as to the location for the fund (usually due to the regulatory or tax regime that they inhabit) and this may have an impact on the jurisdiction of the fund or its structure, or both; feeder vehicles or tax 'blockers' may need to be incorporated into the structure to cater for the specific needs of a single investor or a group of investors.

Other fundraisings can take the form of a wide range of onshore and offshore vehicles such as Luxembourg SICARs/SIFs and French FCPRs or offshore companies, although these structures are aimed at specific markets or at specific types or classes of investor and are not the focus of this chapter.

While each GP will claim to have a set of unique terms relating to its fundraising, there are a number of themes that are common to all, albeit with different formulations and treatment between various funds. While not comprehensive, the main negotiated terms of a private equity fund are as follows.

Target size

The target size of the offering is of relevance to investors as they may wish to impose limits on the size of the fund to ensure that it is not too large for the team to manage, thereby ensuring that they focus on transactions of an appropriate size for their investment strategy. Thus investors may seek to cap the size of a fund and, conversely, seek to subject their commitments to a size condition (i.e., they would only be bound to invest if the fund reaches a 'viable' size), thereby ensuring that they would not be over allocated to that fund or that the fund would have to make smaller investments, in size or number.

GP commitment

The size of the personal commitment made by the executives and its form (i.e., whether it is financed personally, by waiver or some other method) is also very pertinent to prospective investors who want to ensure that they have 'skin in the game'.¹⁶ The expected number used to be in the region of 1 per cent of fund commitments, however,

15 See Section III, *infra*, for more information.

16 *Private Equity International*, 'LPs push GPs to put more "skin in the game"', 21 February 2012.

due to investor pressure this has been steadily increasing and its financing made more transparent and more cash-based.¹⁷

Closing period

This is the period during which more investors can be admitted to the fund. The 'market' position used to be 12 months from the first closing of the fund, however, managers have argued for an increase as a response to the increase in time required to fund raise and deal with investor due diligence, etc. Investors have generally accepted this extended period notwithstanding their concerns that the management team would be distracted from deal sourcing and investment activity by their fundraising efforts.

Investment period

This period during the fund's life is reserved for investing. The manager will have full discretion to draw down all the funds available during this period (subject to relevant limitations such as investment policy and borrowing restrictions). Here, the old *status quo* of a five-year investment period is also being modified. Managers, in an attempt to avoid any risk of failing to invest their funds fully in the allotted period and thereby having to ask for an extension, have argued for the ability to extend their investment periods. This has been met with a variety of responses from investors, some of whom were sympathetic provided that the approval mechanisms were satisfactory, and others who were unmoved and wanted to ensure that their commitments were time limited to five years.

Management fee

Often structured as a profit share, it is usual for the management fee to be calculated as a flat percentage of committed capital during the investment period, stepping down to a percentage of drawn-down or invested capital after the end of the investment period or on the raising of a successor fund. Investors are very sensitive regarding the scale of management fees and their effect on returns and thus there has been some downward pressure and heightened scrutiny by investors.¹⁸

Investment strategy and limitations

The offering will specify the appropriate investment strategy to be followed by the fund and relevant limitations providing, for example, limits in relation to maximum exposure to any one investment sector, jurisdiction or industry limitations as applicable. The investment strategy and limitations are an essential key part of any fundraising and investors are focused on ensuring that they understand any risks and to ensure that there

17 ILPA Version 2.0, 'General Partner Commitment' states that 'the GP should have a substantial equity interest in the fund and that it should be contributed in cash as opposed to being contributed through various management fees'.

18 See ILPA 2.0, 'Management Fee and Expenses' and *Financial Times* articles 'Investors push for private equity fee cuts', 28 February 2012 and 'Private equity profits called into question', 23 January 2012.

is no ‘strategy drift’. The growth in importance of sovereign wealth funds,¹⁹ state-aided funds or political agencies has resulted in a number of pools of capital (e.g., EU regional aid) that are solely focused on a single jurisdiction, or that are prohibited from investing in certain regions, and thus a number of exclusions to the investment policy may be negotiated or ‘side-car’ vehicles with a restricted investment mandate for investing alongside the main fund created in order to cater for these specific investors.

Investment-related fees

The receipt of any transaction fees, break-up fees, directors’ fees or monitoring fees is the subject of much debate among investors and managers. Some, or all, of these fees would typically be set off against management fee so that the investors would receive some or all the benefit thereof and investors have been pushing strongly, and often successfully, for a full set-off in their favour.²⁰ These types of fees are also coming under increasing regulatory scrutiny, notably by the US SEC, which is affecting some major sponsors’ readiness to charge such fees and hence the market position more generally.²¹

Preferred return

There is a surprising lack of movement with the preferred return, notwithstanding today’s low-interest-rate economic environment. Although some funds have created more bespoke arrangements, they are very much in the minority and generally investors are preferring less creativity in structuring the preferred return mechanism.

Carried interest or distribution mechanism

The standard carried interest payable to the manager and its executives in such private equity funds is 20 per cent of fund profits. There are two main methodologies for calculating such carried interest – one being the ‘fund-as-a-whole’ mechanism and the other the ‘deal-by-deal’ mechanism. The former is the most common in Europe, while the latter is most common in the US. As the fund-as-a-whole model is the main European model and is deemed to be investor-friendly in comparison with the deal-by-deal method, most investor negotiations are based around mitigating the risk of any overpayment of carried interest (see below).

Escrow or carried interest clawback

These provisions can be rather bespoke as a number of facts and circumstances are relevant – for example, the distribution mechanism of the fund (see above), the creditworthiness of the carry recipients and the likelihood, in light of the investment strategy, of losses post receipt of carry. The fund-as-a-whole distribution model provides that the carried interest is payable only after investors receive an amount equal to aggregate drawn capital

19 See footnote 13.

20 ILPA 2.0, ‘General Partner Fee Income offsets’.

21 ‘A Few Observations in the Private Fund Space’, David W Blass, Chief Counsel, Division of Trading and Markets, SEC (5 April 2013) (www.sec.gov/News/Speech/Detail/Speech/1365171515178).

and the preferred return thereon, thereby exposing the investors to the risk of carry overpayment if subsequent drawdowns are not fully returned. Escrow mechanisms are usually utilised, although as US investors have generally relied on clawback mechanisms, the market position has changed and thus sometimes one or both structures are used, often in response to the nature of investors, likely return or drawdown profile and the executives' attitude to risk (i.e., do they prefer escrowing or subjecting themselves to a later clawback risk?).

Reinvestment

The ability for a fund to redraw prior distributions is of great importance to the manager to ensure that the fund manager has access to the full amount of investor commitments for the purpose of making investments, including amounts that may have originally been drawn down for management fees or other expenses, bridging investments, etc. The limited partnership agreement will typically set out the type of distributions that can be redrawn and for how long. Certain investors such as funds of funds may be unable to redraw from their own investors and thus push back strongly in this regard.

Exclusivity

This regulates what other funds the manager can raise, and when. This provision comes under discussion as management houses contemplate setting up bespoke side funds or managed accounts, or the manager attempts to diversify into a multi-product asset management platform.

Default provisions

These set out the suite of remedies in relation to investors who default on drawdowns. In light of experiences since the last global financial crisis and threatened and actual defaults, these provisions have become more extensive in their scope.

Key man or suspension of investment period

These provisions have received a lot of investor attention over the past couple of years. They protect the investors from a 'key man event' (i.e., if one or more of the key management personnel ceases to be involved in the management of the relevant fund). As expected the trigger event is heavily negotiated and specific to each fund and sponsor and thus much time and attention is given to this particular provision in fund documentation. This term is often linked with the exclusivity provisions as the ability for a team to perform different functions for different funds is often curtailed.

Removal of the general partner on a 'fault/no-fault' basis

These provisions, alongside the key man provisions (see above), are 'governance' provisions, which have been developing in fund documentation. The relevant voting thresholds and the implications for management fees and carried interest in the case of any such event are often fiercely negotiated as investors seek to ensure that they are sufficiently protected from a manager that has lost its way.

Most-favoured nation

The most-favoured nation (MFN) provision entitles other investors to benefit from rights given by side letter or otherwise to other investors. With the return of fee and carry discounts, preferential co-invest rights and other special deals in this market, there is a renewed focus on the MFN provision. Managers are seeking to limit applicability by size of commitment, legal status, timing of admission, etc., with investors pushing back in this regard.

Other negotiable terms

The high competition for investors' capital and the enhanced due diligence referred to above has resulted in increased investor attention and negotiation on a number of key terms (most mentioned above). The main themes behind investors' negotiations have been increased alignment of interest, governance and transparency – indeed, these are the three guiding principles enunciated in the ILPA Private Equity Principles Version 2.0 published in January 2011²² – and while they, in their own words, 'should not be applied as a checklist, as each partnership should be considered separately and holistically', they are revealing as to the concerns of the investor community and serve as a useful basis for discussions on terms.

Another theme in this market that is having an impact on terms is that of incentives for first closers or large investors. This is often given in the form of a reduced management fee or other economic incentive, although other forms of incentives can be utilised, such as preferred access to co-investments alongside the fund or other enhanced rights. This is very much becoming a feature for fundraisings in this market and a substantial number of funds currently in the market are reported to be offering such incentives.²³

ii Key items for disclosure

The legislative backdrop now set out in the UK Financial Services Act 2012 makes it a criminal offence punishable by up to seven years' imprisonment, a fine, or both, for any person knowingly or recklessly to make a statement, promise or forecast that he or she knows to be misleading, false or deceptive, or dishonestly to conceal any material facts, if he or she does so for the purpose of inducing, or is reckless as to whether it may induce, another person to engage in investment activity.²⁴

Furthermore, a misrepresentation can occur under English law when an untrue statement of fact or law is made that induces the other party to enter a contract and suffer a loss. An action for misrepresentation can be brought in respect of a misrepresentation of fact or law. There are three types of misrepresentation: fraudulent misrepresentation, negligent misrepresentation and innocent misrepresentation. If a party is found to have made a misrepresentation that induced another party into entering in a contract,

22 See <http://ilpa.org/principles-version-2-0/> for ILPA 2.0.

23 http://realdeals.eu.com/mega_market/permira-offers-earlybird-discount- and www.efinancialnews.com/story/2011-09-16/permira-earlybird-discount and www.penews.com/today/index/content/4068927071/restricted.

24 Section 89 of FSA.

there are various remedies that may be awarded by the courts depending on which type of misrepresentation has been found to have occurred. Generally, the remedies for misrepresentation are rescission or damages according to the form of misrepresentation.

Additionally, it is usual for a UK-domiciled manager to be authorised by the UK Financial Services regulator, the Financial Conduct Authority (the FCA) and it would have to comply with the FCA's rules, including the wide-ranging Principles for Business, which include obligations to pay due regard to the information needs of clients and to communicate information to them in a clear, fair and not misleading manner, and the AIFMD.

US securities laws and other law relating to disclosure and fiduciary duties, while outside of the ambit of this chapter, would also be pertinent as most UK offerings would be extended to US investors and thus misstatements, omissions or other misleading content may lead to SEC enforcement, federal or state action, or civil action. European jurisdictions typically also impose similar 'anti-fraud' requirements.

Thus it is important that the manager performs a verification exercise in order to ensure that the investor has subscribed on the basis of the best available facts and thereby minimise the risk of damages claims, recession claims or regulatory sanctions should the fund fail to perform as anticipated. As part of this, the manager will review the offering documents and other related promotions so as to ensure that all facts and circumstances that will be relevant to a potential investor have been adequately disclosed without material omissions, that all statements of fact are accurate, that statements of opinion are reasonable and are honestly held by those to whom they are attributed, and that all inferences which can be drawn from any of those statements are themselves accurate.

As a matter of best practice this verification process should be performed by the manager before issuance of any promotional documents.

The main key items for disclosure to investors are usually set out in the final form offering memorandum, which would typically set out:

- a* the investment highlights, providing a detailed discussion of the investment strategy for the fund and the process by which investments will be made;
- b* the track record of the manager or of the relevant executives comprising the management team;
- c* the *curriculum vitae* of the key executives and relevant experience;
- d* a market overview, so as to provide investors with a macro view of the investment therein;
- e* the summary of key terms (see above);
- f* legal and tax matters, describing various regulatory and tax considerations in making an investment in the fund;
- g* risk factors, so as to make the investors aware of the risks inherent in an investment in the fund; and
- h* a summary of selected investments from the track record of the manager thereby providing the investors with further data and other experience at a granular level.

iii Solicitation

The most common method of solicitation is by way of an offering memorandum, although this document evolves through a number of stages. It is first conceived as a

'teaser' pitchbook, which is distributed to potential investors to solicit their initial interest or as a follow up to preliminary meetings or due diligence. This is then developed into a draft offering memorandum, which is usually circulated to potential investors and is the main promotional document that is used for the 'soft or hard-circling' process before concluding discussions and circulating a final form offering memorandum to investors before the fund's first closing.

In parallel to this process it is common for the manager to establish a data site (usually electronic) containing further information on the manager, track record, executives, legal documentation and structure of the offering. Certain investors also tend to issue their own document and information requests in the form of a due diligence questionnaire (DDQ), which the manager must complete and return. Indeed so common has the DDQ approach become that some managers now pre-complete a 'standard' DDQ for inclusion in the data site so as to expedite the due diligence process. The same considerations as to the accuracy of information provided in the offering memorandum apply to the information provided in the data site or DDQ responses.

Any changes to the terms or other relevant parts of the offering (e.g., track record or revised valuations) that arise as the fundraising progresses are typically communicated to investors by way of an addendum to the offering memorandum.

The manager may also appoint a placement agent who would assist in the preparation of the suite of offering documents and assist in identifying and soliciting potential investors.

Throughout this process the manager and the placement agent, if applicable, must ensure that they comply with the relevant marketing regulations of the pertinent jurisdiction of the investor (including the UK) or whether they have made the appropriate filings or have obtained any required authorisation. While not the subject of this chapter, it should be noted that this body of law has been developing and becoming more extensive (including with various lobbyist and 'pay-to-play' restrictions in the US) and sophisticated placement agents or managers will now generally seek access (via their legal or marketing advisers) to regularly updated global surveys of the marketing or pre-filing and registration rules of each jurisdiction in order to ensure that the offering complies with local laws and regulation.

III REGULATORY AND TAX DEVELOPMENTS

i Regulatory developments

The FCA oversees the marketing of all financial products within (or into) the UK. For the time being, it is not necessary for a non-EU based private equity manager to be authorised by the FCA (or another EU regulator) to market interests in a private equity fund to UK-based institutional investors. Depending on the fund structure, it may also be possible for a non-regulated manager to market fund interests to high-net-worth or sophisticated individuals if certain pre-marketing certification and disclosure requirements are complied with. However, following the implementation of AIFMD in July 2013, active marketing of fund interests to UK investors will generally trigger substantive FCA compliance obligations, even though a non-UK manager is not required to be authorised as such. Managers that are regulated by the FCA have

additional flexibility to market fund interests to a wider range of investors, but following mis-selling concerns, the scope of these exemptions has been reduced with effect from 1 January 2014. Managers authorised under the AIFMD (by the FCA or another EU regulator) can also benefit from the 'marketing passport', entitling them to market fund interests to institutional investors across the EU, including the UK. Passporting rights are also available to smaller managers that fall under the new EU venture capital fund (EuVECA) regime. Placement agents are required to be authorised by the FCA (or by another EU regulator) to carry out placement activities in the UK.

As in other EU jurisdictions, the implementation of the AIFMD on 22 July 2013 has substantially affected the position relating to the marketing of fund interests. The UK AIFMD marketing regulations apply when a fund manager makes a direct or indirect offering or placement of fund interests to or with an investor domiciled or with a registered office in the UK, or when another person (e.g., a placement agent) makes such an offering or placement on the sponsor's behalf, and such marketing activity takes place in the UK. An offering or placement occurs when the sponsor seeks to raise capital by making fund interests available for purchase by a prospective investor, either by making a contractual offer that can be accepted by the investor or by inviting the investor to make an offer to subscribe for interests. As interpreted in the UK, this does not include either soft marketing on the basis of preliminary or draft documentation before there is a substantially final investment proposition, or secondary trading of fund interests where this does not involve the raising of new capital. In addition, the AIFMD marketing rules do not apply where an investor invests at its own initiative on an unsolicited basis (reverse solicitation). The UK's general financial promotion regime continues to apply, including in relation to activity that would not constitute 'marketing' for AIFMD purposes (e.g. where documentation is provided in connection with soft marketing activities or in response to a reverse solicitation) and to any retail offering.

Firms that were both managing a fund and (for non-EU firms) marketing interests in that fund to EU investors as at 22 July 2013 benefit from transitional relief in the UK until 21 July 2014. These firms are permitted to complete their fundraising under the pre-AIFMD rules provided that the fund is closed – at least to UK/EU investors – by that date. Absent transitional relief, firms now fall into three broad groups under the UK AIFMD regulations: EU-based firms who benefit from passporting rights under the AIFMD; EU-based firms who do not benefit from passporting rights under the AIFMD; and non-EU-based firms.

EU-based firms benefit from passporting rights if they are fully authorised under the AIFMD with the financial services regulator in their home jurisdiction and are marketing interests in an EU-domiciled fund to institutional investors. EU-based firms do not benefit from passporting rights if they are not fully authorised under the AIFMD (for example, if they are a smaller firm whose aggregate assets under management is below the authorisation threshold), if they are marketing interests in a non-EU-domiciled fund, or if they are marketing to non-institutional investors, such as high-net-worth individuals. Non-EU-based managers will not be eligible for the AIFMD passport until at least Q4 2015 and possibly later.

Firms who are exercising AIFMD passporting rights are subject to a new pre-approval regime in advance of marketing. A notification must be submitted to the firm's regulator (for UK firms, the FCA) including certain prescribed information about the

firm and the fund and a copy of the fund agreement. The regulator then has 20 working days in which to determine the application, which will be approved unless the regulator has grounds to believe that the firm is not, or will not be, in compliance with the AIFMD. Once approval has been given, the firm is free to market the fund to institutional investors in its home jurisdiction. If the firm wishes to market to institutional investors in other EU jurisdictions, it must notify its own regulator of the jurisdictions in which it wishes to market. The firm's regulator will then notify the regulators in those jurisdictions that the firm is approved for marketing. Once the notification has been made, the firm is free to market to institutional investors in those other jurisdictions.

EU-based firms that do not benefit from passporting rights must continue to comply with the marketing rules applicable in each EU jurisdiction. Broadly speaking, the UK has retained its existing private placement regime for firms that do not benefit from passporting rights, although it has been necessary to introduce some additional notification requirements. Firms authorised under the AIFMD elsewhere in the EU are required to notify the FCA before marketing non-EU (i.e., non-passported) funds to UK-based investors or marketing fund interests to UK retail investors under the certified high-net-worth individual or sophisticated investor exemptions. Sub-threshold UK firms and sub-threshold EU firms that are registered (but not fully authorised) elsewhere in the EU are not subject to any AIFMD marketing restrictions or notification requirements, but must comply instead with the general UK financial promotion regime.

Non-EU firms marketing fund interests under the UK AIFM marketing regulations are now required to notify the FCA prior to marketing and pay the requisite fees, comply with certain regulatory reporting obligations and, if the firm is not a 'small firm',²⁵ comply with the transparency and disclosure requirements and portfolio company provisions prescribed by the AIFMD. These provisions are a subset of the compliance obligations applicable to fully authorised managers and include prescriptive requirements detailing the information to be disclosed to investors prior to investment and on an ongoing basis; a requirement to produce an annual fund report; regulatory reporting requirements; and 'anti-asset stripping' provisions aimed at preventing private equity firms from making distributions from EU portfolio companies within two years of acquisition. Marketing for these firms is also conditional on regulatory cooperation agreements being in place between the FCA and the relevant non-EU regulator(s), although these are now in place with all well-recognised fund jurisdictions.

Ultimately, it is intended that non-EU managers who market fund interests to EU-based investors will be subject to the same regulatory regime as EU-based managers. This would involve managers registering with the appropriate EU regulator (being the regulator in the jurisdiction in which most marketing activity is expected to take place). Once registered, managers over the authorisation threshold would have to comply with the AIFMD in full (not just with the specific provisions described above), but would

25 A firm will be a small firm if its aggregate assets under management (AUM) by portfolio value (disregarding undrawn commitments) do not exceed €500 million for firms managing solely unleveraged funds that have no redemption rights within the first five years and €100 million for other firms.

then be eligible for the marketing passport on the same basis as EU-based firms. This regime may become available on a voluntary basis from late 2015/early 2016, and it is also possible that it will become mandatory from late 2018/early 2019.

In terms of fund structuring, managers are having to decide strategically whether they wish to bring themselves within the full purview of the AIFMD immediately or whether they wish to delay its effect on them by operating offshore. The approach taken here has been mixed to date. Some managers have voluntarily moved their funds onshore so as to deliberately bring themselves within the AIFMD from the start of the new regime, seeing this as a marketing advantage. EQT Partners, for instance, announced on 19 January 2012 that it would launch all future funds onshore, utilising primarily the UK, the Netherlands and Luxembourg as fund jurisdictions so as to fall within the AIFMD regime. Other firms have decided that the costs of full AIFMD compliance, both for the manager and for the fund and its investors (e.g. depositary costs), and the tax implications of domiciling the fund within the EU, outweigh the benefits of the marketing passport and have decided to remain offshore for the time being.

ii Tax developments

One of the main fund structuring objectives is to ensure that the investors in the fund suffer no additional taxes as a result of investing through the fund rather than investing directly in the underlying assets. For this reason, private equity funds in the UK are typically established as limited partnerships so that they are viewed as transparent for most UK tax purposes and do not fall into tax at the fund entity level.

On the basis that the fund is treated as transparent the characterisation of the receipts of the fund as income (e.g., interest or dividends) or capital (e.g., sale proceeds) should be preserved for UK-resident investors (and some other categories of investors – although this is jurisdiction-specific on a case-by-case basis). While this does mean that withholding tax issues can arise without appropriate planning, it does enable investors to secure capital treatment for any carried interest. With a current difference in rates of up to 45 per cent (for income) against up to 28 per cent (for capital) such an objective is important for most UK resident carried interest holders. For those carried interest holders who are UK-resident but domiciled outside of the UK, there is also the possibility to defer or keep the proceeds outside of the purview of the UK tax regime with appropriate structuring.

There are rules in the UK that can treat at least part of a carried interest return as income rather than capital, broadly, by treating the interest as an ‘employment-related security’; however, these rules may not be relevant if the relevant carried interest holder is not an employee in the group (but is instead, for example, a partner in a limited liability partnership) or if the fund is structured so as to fall within the safe harbour outlined by HM Revenue & Customs and the BVCA in a relevant memorandum of understanding.

No recent significant changes have been made to the tax regime on funds, although changes have been made over the past few years to the rules as they apply to UK-resident but non-domiciled individuals (1) requiring them in certain circumstances to suffer an upfront charge to enable them to take the benefit of the remittance basis for future periods and (2) to broaden the range of activities that will be regarded as remittances for UK tax purposes.

IV OUTLOOK

As mentioned earlier, the shake-out within private equity will continue with a large number of fundraisings failing notwithstanding a number of managers being extremely successful with their fundraising efforts. The unsuccessful will be forced into adopting alternative strategies such as deal-by-deal financings, single investor mandates (including managed accounts) or bespoke economic terms. This will increase traffic in secondary partnership interests as investors seek to be released from funds that they perceive are not being supported by the market or also result in novel recapitalisation and restructuring solutions for more mature funds, as mentioned above. Such restructurings will become more commonplace as GPs and their investors seek to address issues raised by the market and an inability to raise new capital and with the renewed focus on 'zombie' funds.

As mentioned in the Regulatory Developments section, Europe is now in the transitional phase of AIFMD, with many private equity houses gearing up for their AIFM application process. This will be a serious change for the industry as some firms choose to operate outside of the AIFMD regime while others take advantage of the marketing passport. The fundraising strategies of a number of private equity firms are still in flux and developing as each firm attempts to ensure its success. As the July deadline looms we will witness further evolution in the industry, as each firm attempts to surf the growing momentum in fundraising.

Chapter 25

UNITED STATES

*Norbert B Knapke II*¹

I OVERVIEW

i Deal activity

While private equity firms closed fewer US deals in 2013 than in 2012, they were nevertheless able to deploy more capital, even closing several very large leveraged acquisitions – a feat that seemed impossible in 2008. The market for exiting investments contracted from the highs of 2012, but 2013 still proved to be one of the best years for monetising private equity investments in a decade, with several large traditional M&A exits and a robust initial public offering (IPO) market. Credit markets continued to expand, allowing firms to refinance existing portfolio companies, frequently using excess proceeds to pay dividends. Nevertheless, equity capital investment continues to lag behind 2007's peak, causing market participants to ask whether the current level of deal activity reflects a new steady state for the industry.

Buyouts

Private equity sponsors completed 20 per cent fewer US buyout transactions in 2013 than 2012, although the deals on average were larger: the aggregate amount invested climbed 6 per cent and the average amount invested was up by 32 per cent.² Much of the increase in invested capital is attributable to 13 deals of US\$2.5 billion or more, including the US\$21 billion Dell acquisition and US\$23 billion HJ Heinz acquisition (two of the largest deals since 2008). Some of the decline in the number of 2013

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2 Pitchbook, PE Breakdown: 2014 Annual Report.

transactions is attributable to a frenzy of deal activity in 2012's fourth quarter, as sellers rushed to complete transactions that otherwise would have closed in 2013 in advance of a US capital gains tax rate increase effective from 1 January 2013.

The 2013 US buyout market compares similarly to the 2011 edition, with the number of 2013 deals about 18 per cent below 2011 levels but with an aggregate value up by about 10 per cent.³ Not surprisingly, the 2013 buyout market was much smaller than the 2007 market: in 2007, private equity firms completed more than 1.3 times as many deals as in 2013 with an aggregate deal value of nearly 2.6 times the 2013 aggregate deal value.

Add-on transactions (i.e., acquisitions by private equity portfolio companies) increased their market share and became a majority of all US buyouts, accounting for 53 per cent of 2013 transactions, up from a 48 per cent share in 2012, a 49 per cent share in 2011 and a 43 per cent share in 2007.⁴

In 2013 private equity sponsors led slightly more acquisitions of US public companies than in 2012 (about 8 per cent more), with a huge increase in aggregate deal value (up over 255 per cent). Two 2013 deals (Dell and HJ Heinz) accounted for nearly all of this increase, so the median value was essentially unchanged.⁵ The 2013 take-private market was similar to 2011, with the same number of deals, but with an aggregate value 79 per cent greater than in 2011 (although the median sponsor-led take-private in 2011 was about 1.5 times larger than in 2013).⁶ As expected, 2013 numbers pale in comparison to 2007, which had almost 2.1 times as many take-private deals as 2013, with an aggregate value of about 3.9 times that of 2013.⁷

Growth equity

In 2013, private equity firms found more, but smaller, opportunities for US growth equity investments (i.e., purchasing a minority equity stake in a firm) than in 2012, with the total number of deals up about 5 per cent, and the average reported value down significantly – about 28 per cent. The number of 2013 growth equity investments was level with 2011, but again the average reported value was much lower (by about 25 per cent). Unlike with buyouts, private equity firms completed more US growth equity investments in 2013 than in 2007, although the average reported deal size was smaller.⁸

Exits

In 2013 the pace of private equity exits shrank from 2012's tax-driven record levels, down 21 per cent by count and returned capital.⁹ However, the 2013 market for private

3 Id.

4 Id.

5 FactSet Mergers.

6 Id.

7 Id.

8 Prequin. 2012 growth equity transactions included two US\$1 billion-plus investments in energy companies.

9 Pitchbook, PE Breakdown: 2014 Annual Report.

equity exits exceeded 2011 levels – 1 per cent by number, and 10 per cent by value – but fell below the highs of 2007.¹⁰

Although exit activity slowed, 2013 still proved to be a very good year for firms looking to monetise their investments. For example, in May a group including Warburg Pincus and Welsh, Carson Anderson & Stowe sold Bausch & Lomb to Valeant Pharmaceuticals for a reported US\$8.7 billion; also in May Bain Capital, CCMP Capital Advisors, JPMorgan Partners and Thomas H Lee Partners sold Warner Chilcott (a pharmaceutical company) to Activis Group for a reported US\$8.5 billion; in June GI Partners sold its cloud computing company Softlayer Technologies to IBM for a reported US\$2 billion; in August Apax Partners and Morgan Stanley sold insurance broker HUB International to Hellman & Friedman for a reported US\$4.4 billion; in November Blackstone sold GeoSouthern (an oil and gas company) to Devon Energy for a reported US\$6 billion; and in December Clayton Dubilier & Rice and KKR sold US Foodservice to Sysco Corporation for a reported US\$8.2 billion.¹¹

The 2013 IPO market was strong, with 57 PE-backed firms closing IPOs, the highest figure in seven years.¹² Portfolio companies in a wide range of industries, such as oil and gas exploration (Antero Resources), consumer products (Coty), health care (Emergency Medical Services), hotels (Hilton and Extended Stay America) and retail (Vince and The Container Store), tapped the public markets.¹³ The fourth quarter was particularly strong, with 18 portfolio companies going public.¹⁴

Pitchbook reports that the market for secondary buyouts (i.e., sponsor-to-sponsor transactions) changed course in 2013 and declined as a share of exits (from 44 per cent in 2012 to 40 per cent in 2013) after steadily grabbing an increasing share over the past several years. IPO exits showed the biggest growth, doubling their share of the market from 5 per cent in 2012 to 10 per cent in 2013.

During 2013, many private equity firms continued the trend of achieving partial liquidity through a technique known as the dividend recap or leveraged dividend, in which a US portfolio company refinances existing indebtedness through additional borrowing and uses the excess funds to pay a dividend, repurchase outstanding shares, or both. According to S&P Capital IQ, 2013 leveraged dividend activity was greater than even 2012's record, with approximately US\$67 billion in new loans for leveraged dividend transactions, compared with US\$50 billion of such new loans in 2012, US\$25 billion in 2011 and US\$35 billion in the last two quarters of 2006 and the first two of 2007.¹⁵ While most of the proceeds of dividend recap loans were used to repay old debt, portfolio company borrowers also distributed a significant portion to their shareholders.

Looking ahead, the market for IPOs, corporate acquisitions and secondary buyouts will become increasingly important for private equity firms looking to liquidate

10 Pitchbook, PE Breakdown: 2014 Annual Report.

11 Prequin.

12 Pitchbook, PE Breakdown: 2014 Annual Report.

13 Prequin.

14 Id.

15 S&P/Capital IQ, LCD's Leveraged Lending Review – 4Q13.

their historically large inventory of portfolio companies (about 7,500), many of which were acquired between 2005 and 2008.¹⁶ And while dividend recapitalisations remain a viable option for returning capital to investors, borrowers may not have much more capacity for such transactions, because as of Q4 2013, nearly 65 per cent of outstanding loans in the S&P/LSTA index had been made for purposes of refinancing or repricing prior debt, or paying a dividend.¹⁷

Financing

The US market for debt financing surged to new heights in 2013, setting all-time records in both the loan and high-yield bond markets. According to S&P Capital IQ, leveraged lending in 2013 was up 30 per cent compared with 2012, with overall M&A financing up 36 per cent and lending to sponsors (for all purposes, including M&A, refinancing and dividend recaps) also up 36 per cent.¹⁸ However, loans made in connection with LBOs took a fairly small share – 14 per cent – of the overall 2013 leveraged loan market. High-yield bond issuances in 2013 surpassed the record set in 2012, albeit by a small margin (1.7 per cent),¹⁹ and even the 2013 volume of second-lien loans (i.e., loans with a security interest subordinate to the lien securing traditional bank debt) was 1.6 times the volume in 2012 (which itself was twice the volume in 2011).²⁰ Yet another sign of the strength of the 2013 US lending market was the growth of ‘covenant-lite’ loans (i.e., loans with minimal financial maintenance covenants), with more than three times as many such loans made in 2013 as in 2007, with an aggregate principal amount about 2.7 times the 2007 amount.²¹

The 2013 market saw continued expansion of buyout leverage, as overall debt levels went up slightly and equity contribution amounts moderated. Total leverage for large corporate leveraged buyouts (defined as issuers with more than US\$50 million in EBITDA (earnings before interest, taxes, depreciation and amortisation)) averaged 5.4 times EBITDA in 2013 compared with 5.3 times EBITDA in 2012, while leverage for middle-market LBOs (issuers with less than US\$50 million EBITDA) averaged 4.8 times EBITDA, compared with 4.5 times EBITDA in 2012.²² At the same time, sponsors’ equity contributions averaged 37 per cent, compared with 39 per cent in 2012.²³

However, data from Q4 2013 suggest these pro-borrower trends will moderate in 2014. Fourth quarter equity contribution levels were higher than the full-year average (44 per cent), and while Q4’s average leverage went up for large LBOs (to six times EBITDA), it declined for middle-market loans (to 4.5 times EBITDA).²⁴ In addition,

16 Pitchbook, Q4 2013 Private Equity Company Inventory Report.

17 S&P/Capital IQ, LCD Quarterly Review – 4Q13.

18 S&P/Capital IQ, LCD’s Leveraged Lending Review – 4Q13.

19 Thomson Reuters, 4Q13 Review and 1Q14 Preview.

20 S&P/Capital IQ, LCD’s Leveraged Lending Review – 4Q13.

21 Id.

22 Id.

23 Id.

24 Id.

in late 2013 US bank regulators issued guidance that may discourage banks under their jurisdiction from financing LBOs with total leverage in excess of six times EBTIDA, which may in turn restrain further growth in leverage levels.

ii Operation of the market

The US market for corporate control is very efficient. Many private targets are sold through an auction run by investment bankers or similar intermediaries. While a smaller proportion of public targets are sold through a full-blown auction, the legal framework (in general) attempts to duplicate an auction by encouraging a target's board of directors to follow a process designed to secure the highest reasonably attainable price for shareholders.

Public targets

From a legal point of view, the US market for sponsor-led going-private transactions is driven primarily by the following considerations:

- a* the fiduciary obligations of the target's board of directors as defined by the laws of the target's state of incorporation (most frequently, Delaware);
- b* financing risks; and
- c* rules of the Securities and Exchange Commission (SEC) regarding tender offers or proxy solicitations.

Each of these factors influences not only the time required to purchase a US public target but also the transaction's structure.

Delaware courts have held that when a target's board decides to sell it must satisfy what are known as *Revlon* duties.²⁵ *Revlon* requires a contextually specific application of the board's normal duties of care and loyalty designed to ensure that it conducts a process to seek and attain the best value reasonably available to the target's shareholders. There is no single, court-prescribed course of action for a board to follow (e.g., conducting a public auction for the target or always using a special committee of disinterested directors to negotiate with a suitor). However, certain conventions – such as fiduciary outs and limits on termination fees and other deal protections – have arisen in response to guidance from Delaware courts to balance the target board's obligation under *Revlon* and the bidder's desire to obtain deal certainty.

Since the private equity-led going-private market came back to life after the 2008 financial crisis, many deals feature the so-called 'go-shop' exception to a target's customary

25 *Revlon v. McAndrews & Forbes Holdings, Inc* (Del Sup Ct 1986). Many states do not follow *Revlon*; some states, such as Indiana (Indiana Code, Section 23-1-35-1(d)), Pennsylvania (Pennsylvania Business Corporations Law, Section 1715) and Wisconsin (Wisconsin Business Corporations Law Section, 180.0827), have constituency statutes permitting directors to consider not only price but also other stakeholders' interests, such as the target's employees, suppliers and communities in which the target operates, when considering a sale.

‘no-shop’ covenant.²⁶ In a typical go-shop, the target is given a window – usually 25 to 40 days – to actively seek a superior offer. If a qualifying topping bid emerges during the go-shop period, the target may terminate its agreement with the original acquirer by paying a reduced termination fee and enter into a new agreement with the higher bidder. Most importantly, from a private equity bidder’s perspective, Delaware courts have concluded that a target board that does not conduct a pre-signing auction or market check can satisfy its *Revlon* duties by including a go-shop in the merger agreement, so long as the rest of the process and other deal protections are satisfactory.²⁷

The go-shop structure allows a private equity buyer to approach a desirable take-private target board and, if the parties can agree on a fair price, conduct confirmatory due diligence and finalise the terms and conditions of the transaction – including a go-shop – quickly and privately. As long as the other facts and circumstances of the process pass *Revlon* muster,²⁸ this approach allows target directors to satisfy their duties, while avoiding a time-consuming, uncertain and potentially damaging public auction.²⁹ In exchange, the private equity bidder accepts the risk that the target may find a topping bid during the go-shop period – an unusual occurrence, according to the FactSet Mergers database.³⁰

Parties to a US leveraged take-private must contend with the risk that debt financing may not be available at closing. Unlike some other countries (e.g., the United Kingdom), ‘certain funds’ (a fully negotiated and executed credit agreement between a buyer and its lenders delivered at deal announcement) is neither required nor available in the US, and financing commitment letters, no matter how ‘tight’ (i.e., lacking in pre-conditions) cannot be specifically enforced even if the providers of such letters have clearly breached their terms. In response, dealmakers have crafted a model that has become the most common (but by no means the sole) way to allocate the risk of financing failure.

This model generally allows a target to obtain specific performance, and only specific performance (i.e., no claim for damages), of a buyer sponsor’s commitment to

26 A ‘no shop’ covenant prohibits the target from actively seeking an acquisition proposal, but typically allows a target to respond to an unsolicited proposal that could lead to a better transaction for target shareholders.

27 See, for example *In re Topps C S’holder Litigation* (Del Ch 2007) and *In re Lear Corp S’holder Litigation* (Del Ch 2007). There are many dimensions to a go-shop’s terms, such as the length of the go-shop period, the size of the reduced fee and limitations on what constitutes a superior offer, each of which is taken into account when evaluating the board’s compliance with *Revlon*.

28 For an example of a transaction in which Delaware courts questioned the target board’s process, see *In re Del Monte Foods S’holders Litigation* (Del Ch 2011).

29 The inherent flexibility of *Revlon* allows dealmakers to craft creative solutions to meet the needs of any particular transaction. For example, see Ginsburg, Levin and Rocab, *Mergers, Acquisitions, and Buyouts – Transactional Analysis* (Wolters Kluwer, September 2013), ¶1702.11.5, for a description of a hybrid no-shop/go-shop provision.

30 Of the deals in FactSet’s database (dating back to 2003), 223 had a go-shop, only 16 of which were ‘jumped’ during the go-shop period. An additional 10 deals were ‘jumped’ outside the go-shop period.

provide the necessary equity financing and to complete the merger if, and only if, all of the conditions to the merger are satisfied, the debt financing is available for closing and the target agrees to close when the equity is funded. If, on the other hand, the private equity sponsor is unable to close because the necessary debt financing is not available, then the sponsor must pay the target a reverse break-up fee (usually an amount greater than the target's termination fee) and the transaction is terminated. Payment of the reverse break-up fee is the target's sole and exclusive remedy against the sponsor and its financing sources, even in the case of a wilful breach.³¹

Parties to a sponsor-led take-private transaction add yet another level of complexity when they choose to proceed via a two-step tender offer (rather than a one-step merger). In a tender offer, the sponsor offers to purchase the shares of the target directly from the shareholders, obviating the need – at least in the initial step – for a shareholder vote. The sponsor's obligation to complete the tender offer is typically conditioned upon shareholders tendering more than 50 per cent of the outstanding shares. If the minimum tender condition is satisfied, the sponsor must acquire all untendered shares in a 'back-end' merger, the terms of which are set out in a merger agreement executed by the target and buyer on the day they announce the tender offer. Depending on the circumstances of the deal, including the target's state of incorporation, the 'back-end' merger can either be completed immediately after closing the tender offer, or only after a long (three to four months) and expensive proxy solicitation process and a shareholders' meeting.

Failure to acquire all of the outstanding share on the same day the tender offer closes makes it much more difficult to use debt financing due to the application of US margin rules, a highly complex set of laws and regulations that, in general, prohibit any person from financing the acquisition of US public company shares with more than 50 per cent debt financing secured by the target's shares or assets. Many sponsor-led US take-private transactions are more than 50 per cent leveraged, so parties to such transactions must find solutions that satisfy the margin rules if they wish to enjoy the benefits of a tender offer.

The easiest way to avoid a delayed back-end merger is for shareholders to tender to the buyer a supermajority of the target's shares – in Delaware 90 per cent – allowing the buyer to complete a 'short form' merger immediately after closing the tender offer. In most deals, however, it is not realistic to expect shareholders to tender such a large proportion of the outstanding shares.

In response, dealmakers have created two innovative techniques to avoid the potential delays of a full-blown back-end merger process and the complications presented by the margin rules: the top-up option and the dual-track or *Burger King* structure. In addition, in August 2013 Delaware – by far the most common state of incorporation for US-listed companies – enacted Delaware General Corporation Law Section 251(h),

31 Not all deals follow this model. In smaller deals, some sponsors have assumed all of the financing risk and granted the target full specific performance; on the other, rarer end of the spectrum, buyers have agreed to a two-tiered reverse break-up fee, with a smaller fee payable if debt financing is unavailable, and a larger fee payable if the sponsor breaches its obligation to close (even if debt financing is available).

giving dealmakers yet another way to close a tender offer and back-end merger on the same day.

Top-up option

In a top-up option the target agrees, upon completion of the tender offer, to issue to the buyer a sufficient number of its authorised but unissued shares to allow the buyer to reach the short-form merger threshold. By completing the back-end merger essentially simultaneously with the tender offer, a sponsor can more easily structure its debt financing to comply with the margin rules and lender demands for a lien on the target's assets. Delaware courts have approved the top-up option structure, with a few easily satisfied caveats,³² largely because it puts money in shareholders' hands more quickly without harming their interests. The primary limitation of the top-up option is mathematical: the number of shares required to hit 90 per cent may be very large because the calculation is iterative, so it is often the case that a target does not have enough authorised but unissued shares in its constituent documents to utilise the top-up option.

Burger King structure

In the acquisition of Burger King by hedge fund 3G Capital Management, the target did not have enough authorised but unissued shares to allow for a 50 per cent plus 1 minimum tender condition and a top-up option. In response, the parties created a dual-track structure in which 3G launched a tender offer with a top-up option and a 70 per cent minimum tender condition – the lowest minimum condition that Burger King's authorised but unissued shares could support under the top-up option – and the parties simultaneously initiated a proxy solicitation for a one-step process that would replace the tender offer in the event the 70 per cent minimum condition was not reached. Since its invention, the *Burger King* dual-track structure has been used by private equity and strategic buyers alike,³³ allowing parties to find the fastest possible path to acquire all of the target's shares without running afoul of the margin rules.

Section 251(h)

In August 2013 Delaware added Section 251(h) to its corporate merger statute, eliminating the requirement for shareholder approval of a back-end merger after a tender offer for a listed company or one with more than 2,000 shareholders of record if in the tender offer the buyer acquires more than the number of shares required to approve a merger but less than the 90 per cent threshold for a short-form merger. Section 251(h) incorporates a

32 See *Olson v. ev3, Inc* (Del Ch 2011). The buyer must pay cash for at least the par value of the issued shares (with the remainder purchased with a demand note, the terms and conditions of which were approved by the target's board), and the top-up option shares must be ignored if any dissenting shareholder elects to seek an appraisal of its shares.

33 See for example *PF Chang's/Centerbridge Partners* (announced 1 May 2012), *Cost Plus/Bed Bath & Beyond* (announced 9 May 2012) and *JDA Software/New Mountain Capital* (announced 1 November 2012), *Buckeye Technologies/Koch Industries* (announced 24 April 2013) and *Greenway Medical Technologies/Vista Equity Partners* (announced 23 September 2013).

number of conditions, the most important of which for purposes of private equity buyers are: (1) at the time the target's board approves the related merger agreement (which must expressly elect to be governed by Section 251(h)), no party to the merger agreement is an 'interested stockholder' (shareholder) as defined in Section 203(c) of the Delaware General Corporation Law (generally, a 15 per cent owner, together with its affiliates and associates); and (2) the non-tendered shares must receive the same consideration in the merger as the tendered shares received in the tender offer.

Section 251(h) is an important and useful innovation, as it allows the buyer to acquire all of the outstanding shares and the non-tendering shareholders to receive the merger consideration without the lost time and expense of a three- to four-month proxy solicitation process. However, Section 251(h) has not supplanted the top-up option or the *Burger King* structure, because the 'no interested stockholder' and 'same consideration' conditions can cause headaches for private equity (and other) buyers. First, the 'no interested stockholder' condition will prevent a buyer from using Section 251(h) and entering into support agreements with a target's existing shareholders – a common tactic in sponsor-led take-privates – if by doing so it could be deemed to own 15 per cent of the target's shares. Second, private equity buyers often give target management or other significant target shareholders the opportunity to exchange all or a portion of their target stock for buyer shares, which would run afoul of the 'same consideration' condition. As a result, many deals still utilise a top-up option or the *Burger King* structure, either in lieu of or as a backup in the event the Section 251(h) conditions cannot be satisfied.³⁴

Private targets

Because it is easier to maintain confidentiality and the consequences of a failed auction are less dire, a full-blown auction for a US private target is more common than for a public target. In an auction for a US private target, the target's advisers typically invite several bidders to conduct limited due diligence and submit indicative bids, with the highest and most credible bidders invited to conduct further due diligence and submit additional bids. The time required to sell a private target can vary considerably: a competitive auction for and sale of a desirable private target can take as little as two months, while it may take many months to sell other companies (whether desirable or not). If the buyer requires debt financing, the health of the debt markets also affects the length of the process.³⁵

In an auction a private equity firm must compete not only on price but also on terms, timing and attractiveness to management. While in the past private equity bidders often conditioned their bids on receiving necessary debt financing, in today's market such a condition likely will adversely affect the competitiveness of a bid, particularly in

34 In addition, top-up options and the *Burger King* structure may still be used if the target is not incorporated in Delaware and the applicable state law does not have a Section 251(h) analogue.

35 While in theory *Revlon* and related principles of Delaware law apply equally to the sale of a private target as to a public target, in practice a buyer often is transacting directly with target shareholders (or at least controlling shareholders), minimising or even eliminating the board of directors' role and the related legal issues.

a larger deal. Indeed, in the current market many private-target acquisition agreements (a clear majority in larger deals) contain the same conditional specific performance and reverse break fee mechanism now common in take-private transactions.

The US buyout market has also seen continued growth in the use of commercial insurance policies intended to protect buyers, sellers or both against various transaction-related risks, such as breaches of representations and warranties. These insurance products often allow parties to bypass difficult negotiation over post-closing indemnification by shifting specified transaction risks to a sophisticated third party. An increasing number of private equity firms have successfully used M&A insurance to either make their bids more attractive to sellers or limit their post-closing liabilities when exiting an investment.

Management equity

Management equity practices vary across US private equity firms, but certain themes are common:

- a* executives with sufficient net worth are expected to invest side-by-side with the sponsor to ensure they have sufficient ‘skin in the game’;
- b* management equity entitles the holder only to modest shareholder rights – in some cases, only the right to be paid in connection with a distribution or liquidation;
- c* holders of management equity get liquidity when and to the same extent that the sponsor gets liquidity; and
- d* incentive equity (and at times part or all of management’s co-invested equity as well) is subject to vesting, whether upon passage of time, achievement of various performance goals, or a combination of both.

The size of the management incentive equity pool generally ranges from 5 per cent to 15 per cent, with smaller deals congregating at the upper end of the range, and larger deals at the lower end.

The prospect of participating in a potentially lucrative incentive equity pool can be a powerful motivation for management to prefer a private equity buyer over a strategic buyer unlikely to offer a similar plan (and who might offer pink slips instead). A private equity bidder for a private target can use this to its advantage, particularly when management cooperation is key to a successful sale. When pursuing a public target, however, such a strategy carries additional risk, as Delaware courts, the SEC and the market are sensitive to the conflict of interest presented when a target officer – particularly the CEO – has a personal incentive to prefer one bidder over another.

For this reason, the board of a public target often instructs its management not to enter into an agreement with a private equity suitor regarding compensation or equity participation before the shareholders have voted on the deal (or tendered their shares to the buyer). Indeed, it is often in a private equity buyer’s interest not enter into an agreement with management before the shareholder vote, because the SEC (by way of its Rule 13e-3) requires substantial additional disclosure in such situations. In addition, management participation in a transaction prior to a shareholder vote may increase the risk (and potentially cost) of shareholder lawsuits opposing the deal.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

The US federal system – in which the federal (i.e., national) government exercises supreme authority over a limited range of issues, and the individual states exercise authority over everything else occurring within their respective jurisdictions, with overlaps seemingly everywhere – presents private equity firms with a complex legal maze to navigate when acquiring control of or investing in the equity of a target company. A private equity firm contemplating an investment in the US confronts the following regulatory regimes:

- a* federal securities laws and regulations, administered by the SEC;³⁶
- b* state corporation (usually the Delaware General Corporation Law) and alternative business entity (usually the Delaware Limited Liability Company Act or the Delaware Limited Partnership Act) laws and state securities laws (called ‘Blue Sky’ laws);
- c* federal, state, local and foreign tax laws and regulations;³⁷
- d* Hart-Scott Rodino Antitrust Improvements Act (the HSR Act) pre-merger antitrust review;
- e* particularly when making a minority investment in a public target, the rules of the stock exchange where the target’s shares are listed, such as the New York Stock Exchange or the Nasdaq National Market;
- f* potential review by the Committee on Foreign Investment in the US of an investment by a non-US investor in a US target, if the investment threatens to impair national security;³⁸ and
- g* industry-specific regulatory schemes – such as those found in the energy, pharmaceutical, medical device and telecommunication industries – that may require advance notification to or even approval by a governmental authority.

The first three regulatory schemes – federal securities laws, state corporate and securities laws, and tax – affect every investment a private equity firm may make in the United States. The HSR Act applies only if a deal exceeds specified levels,³⁹ and the applicability

36 In April 2012, the JOBS Act became law. The JOBS Act contains a number of changes to US federal securities laws and regulations, most of which are intended to make it easier for small businesses to raise capital. While the JOBS Act is expected to benefit US private equity fundraising, it likely will have little impact on US private equity transactions.

37 The tax implications of any private equity transaction are tremendously complex. For a thorough discussion of such issues, see generally Ginsburg, Levin and Rocop (footnote 29).

38 See Laura L Fraedrich and Daniel J Gerkin, ‘Treasury Proposes Regulations Implementing Foreign Investment and National Security Act’, Kirkland Private Equity Newsletter (13 June 2008), www.kirkland.com/siteFiles/Publications/3ED260166BA840000799E25258839EF4.pdf.

39 See Kirkland Alert (January 2014) for the most recent HSR filing thresholds, available at www.kirkland.com/siteFiles/Publications/Alert_012314.pdf.

of the others depends on the nature of the target and, in some cases, the characteristics of the buyer as well.

In general, neither US federal securities laws and regulations nor Delaware corporate and other business entity laws focus upon the substance of a transaction. Rather, the federal scheme is designed to ensure that parties to the transaction – whether a direct sale of shares, a merger, a tender offer or issuance of shares – make and receive adequate disclosure, and in some cases adequate time to make a fully informed investment decision, and Delaware law is chiefly concerned with the process followed by the company's governing body when considering the transaction.

ii Fiduciary duties and liabilities

Corporations

In general, shareholders of a Delaware⁴⁰ corporation do not owe any duties, fiduciary or otherwise, to one another. Thus, a private equity firm is free to act in its own interest, subject to very limited exceptions,⁴¹ when deciding to vote or sell its portfolio company shares, subject to contractual rights (e.g., tag-along or registration rights) of the company's other shareholders. On the other hand, a controlling shareholder may be liable to the corporation or its minority shareholders if the controlling shareholder enters into a self-interested transaction with the corporation at the expense of the minority.⁴²

All directors (and officers) of a Delaware corporation, including sponsor representatives on the board, owe the corporation and its shareholders the following duties:

- a* a duty of care, requiring a director to be reasonably informed and to exercise the level of care of an ordinarily prudent person in similar circumstances;
- b* a duty of loyalty, requiring a director to act in the interests of the corporation and its shareholders and not in his or her own interest; and
- c* a duty of good faith, or perhaps better stated a duty not to act in bad faith, often described as the intentional or reckless failure to act in the face of a known duty, or demonstrating a conscious disregard for one's duties.

Subject to limited exceptions, when reviewing the conduct of a corporation's directors Delaware courts will apply what is known as the 'business judgement rule', which presumes that a director acted with reasonable care, on an informed basis, in good faith and in the best interest of shareholders, and not second-guess the director's decisions. Only if a plaintiff proves that a director made an uninformed decision or approved a self-interested transaction will the courts apply the 'entire fairness' doctrine and require the director to prove that the price and the process leading to the disputed transaction were fair to the corporation and its shareholders. In addition, when reviewing certain transactions, such as the imposition of defensive measures (e.g., a poison pill) or the sale

40 This section deals only with the laws of Delaware. The laws of other states may be materially different.

41 See, for example, *Abraham v. Emerson Radio Corp* (Del Ch 2006).

42 See, for example, *In re Lorol Space and Communications Inc* (Del Ch 2008).

of control (see the *Revlon* discussion in Section I.ii, *supra*), Delaware courts apply what has come to be known as ‘enhanced scrutiny,’ a standard more rigorous than the business judgement rule but less than entire fairness, in which the court reviews the adequacy of the process leading to the challenged transaction and whether the price was reasonable.

Delaware law also allows a corporation to exculpate its directors (but not officers) from monetary liability for a breach of the duty of care,⁴³ and to indemnify its directors and officers against claims and expenses arising out of the performance of their board duties.⁴⁴ Such exculpation and indemnification are not available, however, for any director or officer found to have breached the duty of loyalty.

A sponsor representative on the board of a Delaware corporation must also be aware of the corporate opportunity doctrine, under which a corporate officer or director must offer the corporation any business opportunity that the corporation is financially able to undertake, is within the corporation’s line of business and with respect to which the corporation has an interest. The corporate opportunity doctrine can cause a problem for a sponsor owning or expecting to invest in a competing or similar business, but it can be disclaimed if appropriate language is included in the corporation’s articles of incorporation.

If a Delaware corporation has preferred and common shares, its board owes its duties only to the common shareholders if there is conflict between their interests and those of the preferred shareholders.⁴⁵ If a corporation is insolvent (or in bankruptcy), then the board’s fiduciary duties are owed to the corporation’s creditors, not its shareholders.⁴⁶ If a financially struggling corporation is in a grey area known as the ‘zone of insolvency’, then its directors have a duty to maximise the enterprise value of the corporation for the benefit of all those with an interest in it.⁴⁷

Limited liability companies (LLCs)

Recently, private equity firms have begun to prefer Delaware LLCs over corporations when structuring an investment. Delaware law allows sponsors and their co-investors to craft LLC governance provisions, including the total elimination of voting rights and fiduciary duties (other than the contractual duty of good faith and fair dealing),⁴⁸ which streamline decision-making and avoid potential personal liability of sponsor board representatives. The added flexibility of an LLC is both a benefit and a burden, as Delaware courts have consistently held that any modification to traditional corporate principles must be clearly and unambiguously stated in the LLC’s operating agreement; otherwise, traditional corporate principles will apply (perhaps in unexpected ways).

43 Delaware General Corporation Law, Section 102(b)(7).

44 Delaware General Corporation Law, Section 145.

45 *In re Trados* (Del Ch 2013).

46 *Geyer v. Ingersoll* (Del Ch 1992).

47 *North American Catholic Educational Programming Foundation, Inc v. Gheewalla* (Del Sup Ct 2007).

48 See footnote 29, *supra* and Ginsburg, Levin and Rocap (footnote 29 *supra*), Paragraph 1602.3.

An LLC structure eliminates double tax (at the corporate and shareholder level) and thus can also be more tax-efficient for certain investors. Non-US investors who are not US taxpayers, however, must exercise caution when investing in an LLC, as they may be obligated to pay US income tax on their US effectively connected income and to file a US tax return.

III DEBT FINANCING

The huge US market for acquisition debt financing is highly sophisticated and efficient, with many experienced investors and service providers and multiple options for a private equity sponsor seeking to finance an acquisition. While the market has recovered from its post-financial crisis lows, it remains sensitive – particularly for deals over US\$100 million – to changes in the broader markets.

No two deals are the same, and the availability of certain types of debt financing depends on market conditions, but US LBO financing structures typically fit into one of the following categories:

- a* senior and bridge loans, with the bridge loan usually backstopping a high-yield bond offering, typically used in very large deals;
- b* first-lien and second-lien loans, typically used in upper middle-market deals, with the availability and pricing of second-lien debt highly dependent on market conditions;
- c* senior and mezzanine loans, typically used in lower- to upper-middle-market deals; and
- d* senior loan only, typically only used in smaller deals or deals in which the private equity sponsor is using very little leverage.

Except for smaller deals (US\$100 million or less), most lending facilities are arranged by a financial institution and then syndicated to other lenders,⁴⁹ including banks, hedge funds and special purpose entities – known as collateralised loan obligations (or CLOs) – created to invest in such loans.

Because UK-style ‘certain funds’ debt financing is not available in the US, the parties to an LBO – the lenders, the private equity sponsor and even the target – inevitably face market risk between execution of the acquisition agreement and closing. Those parties, particularly the sponsor, must therefore carefully manage that risk in the transaction agreements, especially in the interplay among the debt and equity financing commitment letters and the acquisition agreement.⁵⁰

The non-pricing terms (excluding items such as fees, interest rates and original issue discounts) of an LBO loan – such as affirmative, negative and financial covenants, collateral requirements and defaults – vary considerably from one deal to the next based

49 The ‘marketing period’ for a syndicated loan, during which the institution arranging the loan assembles the lending syndicate, typically runs for between three and four weeks.

50 See discussion in Section I, *supra*.

on the size of the transaction and the perceived creditworthiness of the borrower.⁵¹ In general, however, loans for smaller deals are more similar to one another with respect to affirmative, negative and financial covenant requirements. Non-pricing terms for larger loans occupy a wide spectrum ranging from a full covenant package to ‘covenant-lite’ loans, where financial maintenance covenants apply only to revolving credit facility draws in excess of a specified amount. In a syndicated loan, key terms, including pricing and debt structure, are typically subject to change in favour of the lenders – referred to as ‘flex’ – in the event that the loan cannot be syndicated in the absence of such changes (which may not include, however, additional conditions precedent to funding).

IV OUTLOOK

While it is tempting to compare the current US market for private equity investments to the 2006/2007 peak, few (if any) observers expect the volume of private equity deals to approach those levels soon. Viewed in that light, 2013 was a very good year for the US private equity industry, with 2014 shaping up to be a very good year as well. Buyout funds have an abundant supply of uncalled capital; the supply of debt financing remains solid; the public equity markets appear to remain receptive to sponsor-backed IPOs; and strategic buyers continue to hold large amounts of cash, ready to be spent on new acquisitions. US private equity firms have also proved their mettle in recent years, with many posting solid returns in the midst of the recession, others successfully managing the difficult process of leadership change, and the industry as a whole adapting to an entirely new regulatory regime. In addition, many large US private equity houses have broadened their mandates to diversify their businesses. While risks remain, such as the impact of changes US Federal reserve policies and an expected rising interest rate environment, these are risks common to the overall economy and ones which private equity professionals have faced before.

51 Many middle market and most – if not all – larger loans are rated by credit rating agencies such as Standard & Poor’s and Moody’s.

Appendix 1

ABOUT THE AUTHORS

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Pierre-Luc Arsenault is a partner in the Hong Kong office of Kirkland & Ellis International LLP. He focuses his practice on the representation of strategic and private equity clients in complex business transactions, including mergers and acquisitions, divestitures, leveraged buyouts, recapitalisations and joint ventures. His experience also includes advising clients in Asia on corporate governance matters. Mr Arsenault has handled matters for several private equity clients, including Advantage Partners, Bain Capital, Blue Point Capital Partners, FTV Capital, Oaktree Capital Management and Warburg Pincus.

MARK MIFSUD

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Mark Mifsud is a private funds partner in the London office of Kirkland & Ellis International LLP and has been consistently recognised as a leading lawyer in his field. *Chambers UK* has, in its 2013 edition, again ranked Mr Mifsud as Tier I and it also ranked the London private funds practice as top-tier in London. It noted that Mr Mifsud is 'a superb lawyer in this field'.

He has extensive experience in advising private fund managers in relation to the structuring and establishment of a wide range of private investment funds, including private equity, real estate, infrastructure and debt funds and also secondaries, incentive schemes, carried interest arrangements and co-investment plans, all on an international basis. He also advises private investment managers, significant limited partners and other parties on related matters and general corporate finance.

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David Patrick Eich is the founding partner of the Asian offices of Kirkland & Ellis and leads the firm's global private equity practice in Asia, representing financial and strategic sponsors and their affiliates in multi-jurisdictional leveraged buyouts and acquisitions, growth equity investments, joint ventures, fund formations and other complex private equity and corporate transactions. Qualified in the United States as an attorney and in the United Kingdom and Hong Kong as a solicitor (he is also a registered foreign lawyer in Germany), he has closed many deals around the world for a large number of private equity and strategic sponsors since 1994.

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Mr Knapke received his BA degree in 1987 from the University of Notre Dame, where he graduated *magna cum laude* and was inducted into the Phi Beta Kappa Society. He received his JD in 1992 from the Duke University School of Law, where he was a member of the Duke Law Journal editorial board, graduated *magna cum laude*, and was inducted into the Order of the Coif. After law school, Mr Knapke clerked for the Honourable John T Noonan, Jr, a judge on the US Court of Appeals for the Ninth Circuit.

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Mr Mena is a graduate of the University of Chicago Law School (LLM, 2000) and the Universidad de Chile in Santiago (JD, 1998). Prior to being admitted to the New York Bar, he practised in Chile as an associate at Morales & Besa in Santiago, focusing on corporate finance matters.

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Salvador Valdés is a partner in the M&A practice group of Carey. He represents Chilean and international clients in mergers and acquisitions, joint ventures, financings and corporate restructurings. He also regularly advises banks, financial institutions and insurance companies in regulatory matters, securities offerings and derivatives

transactions. Mr Valdés has worked on some of the most important M&A and private equity transactions in the Chilean market in recent years.

He is a professor of commercial law at Universidad Católica de Chile. He graduated from Universidad Católica de Chile, Law School (1992), and obtained a master of laws degree (LLM) from the University of Chicago Law School (1996). Between 1996 and 1997, Mr Valdés worked with Shearman & Sterling LLP, New York, focusing on M&A matters.

Mr Valdés has been recognised as one of the leading lawyers in Chile by recent surveys conducted by *Chambers & Partners* (Corporate M&A Band 1, 2010, 2011, 2012 and 2013), *IFLR*, *Practical Law Company* and *Latin Lawyer*.

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