Chambers

GLOBAL PRACTICE GUIDE

Definitive global law guides offering comparative analysis from top ranked lawyers

Private Equity

USA: Law & Practice
Bartlit Beck LLP

2019

chambers.com

Law and Practice

Contributed by Bartlit Beck LLP

Contents

Bartlit Beck LLP has established itself as a premier provider of high-quality legal services to private equity funds focused on the middle market as well as operating companies in the space. The firm uses small, cohesive deal teams with deep expertise and the active involvement of senior lawyers to provide sophisticated hands-on legal advice. It offers flexible billing as an alternative to hourly rates to align its incentives with its clients. Bartlit Beck's lawyers have experience in a wide variety of transactions, including in mergers and acquisitions (negotiated and hostile), securities offerings and compliance issues, corporate finance, hedge and private equity fund formation, and counseling on sensitive corporate governance matters. Headquartered in Denver, Colorado, Bartlit Beck prides itself on providing sophisticated, efficient solutions and is dedicated to understanding its clients' business and playing a critical role in their most important transactions.

Authors

Rob Morrill is a partner in Bartlit Beck's corporate group in Denver, Colorado. Rob focuses his practice primarily on M&A transactions, and has extensive experience representing private equity funds in leveraged acquisitions and dispositions. He also serves as principal outside counsel to several portfolio companies of fund clients and advises clients on a wide variety of general corporate and transactional matters.

Noah Goodman is an associate in Bartlit Beck's corporate group in Denver, Colorado, where his practice is principally focused on M&A transactions, including the representation of private equity funds and their portfolio companies in leveraged acquisitions and dispositions. In addition, Noah advises businesses on a wide variety of general corporate and transactional matters.

Benjamin Smith is a partner in Bartlit Beck's corporate group in Denver, Colorado, where his practice is focused on mergers and acquisition transactions, including the representation of private equity funds and their portfolio companies in leveraged transactions, finance and securities-related transactional matters and representation of hedge funds, private equity funds, portfolio companies and other businesses in a variety of fund and general corporate matters.

Phillip Cushing is an associate in Bartlit Beck's corporate group in Denver, Colorado. Phil's practice focuses on representing private equity funds and their portfolio companies in M&A and related financing transactions. Phil also regularly advises public and private companies on general transactional and corporate governance matters.

1. Trends

1.1 M&A Transactions and Deals

Continued healthy levels of credit and record levels of private equity capital continue to translate into strong private equity M&A activity in the USA. While the number of both buy-outs and exits appears to have tapered modestly in 2019, overall value remains high, reflecting larger deal sizes if not volume. This is consistent with persistently high valuations of private targets amid an increasingly competitive landscape of private equity buyers with high levels of dry powder, further fuelled by low interest rates and aggressive participation in the market by strategic buyers. High valuations tilt private equity buyers toward targets with significant growth opportunity, narrow the scope of viable investments and further inflate valuations of the highest quality targets while forcing many funds in a crowded private equity field to exercise continued restraint.

The use of representation and warranty (R&W) insurance in private equity deals continues to increase, offering buyers more flexibility to allocate risk away from sellers in an already seller-friendly market. Auction processes remain commonplace among quality targets, and sellers are less inclined to award exclusivity to bidders until late in the process. Competitive processes often force buyers to be prepared to close within short periods after final bids. Consequently, successful bidders are increasingly required to front-load due diligence to early in the auction, conducting much or all pre-signing work before a winning bidder is selected.

1.2 Market Activity

In 2019 private M&A activity is healthy across most sectors and is particularly strong in technology and healthcare sectors.

2. Legal Developments

2.1 Impact on Private Equity

The 2017 Tax Cuts and Jobs Act led private equity funds to consider significant changes in acquisition deal structures. Factors included in structuring decisions now include the option to expense 100% of tangible assets of a target in the same tax year as the acquisition, net operating loss deductions and interest expense limitations. The reduced corporate tax rate, elimination of corporate AMT and several favourable tax characteristics of corporations have expanded the options in entity choice in a market previously dominated by pass-through structures such as limited liability companies.

The Foreign Investment Review Risk Modernization Act of 2018 expanded the scope of CFIUS (discussed in **3.1 Primary Regulators and Regulatory Issues**, below) in the context of transactions involving certain critical infrastructures and technologies or personal data, with further rules and guidance to come from the U.S. Department of Treasury.

The expansive scope of several recent privacy law developments (including the EU's General Data Protection Regulation and California's Consumer Privacy Act of 2018) has had a global impact on most companies with significant operations involving personal data, and private equity funds have adjusted pre-acquisition due diligence and post-acquisition compliance monitoring practices to identify and manage the potential exposure under a new legal paradigm rapidly shifting toward enhanced personal privacy rights and substantial penalties for non-compliance.

Courts in Delaware (the most important US jurisdiction for corporate transactions) have recently issued important decisions breaking new ground or clarifying legal matters of particular importance to private equity M&A participants, including:

- for the first time finding a material adverse effect supporting a buyer's right to terminate an acquisition agreement (where an estimated 21% reduction in the target's value resulted from a host of legal compliance failures);
- opening the question of whether a claim for breach of representation in an acquisition agreement may be defeated if a buyer knew the representation was false at the time of signing;
- strengthening contractual and fair market value defences to appraisal claims; and
- further solidifying a seller's ability to disclaim liability for fraud outside of the acquisition agreement.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

US federal regulation of private equity M&A transactions is typically focused on three areas: oversight of the offering and sale of securities in an M&A transaction, clearance of transactions for antitrust compliance and review of transactions involving foreign investment for national security concerns.

Oversight of Offering and Sale of Securities in M&A Transactions

The U.S. Securities Exchange Commission (SEC) and various states regulate the sale of securities. Oversight is limited in M&A transactions between sophisticated, accredited investors except in public acquisitions or where securities are offered to a large group of sellers as part of the acquisition consideration.

Clearance of Transactions for Antitrust Compliance

Under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the HSR Act) and other applicable federal statutes, antitrust oversight is the domain of the U.S. Department of Justice (DOJ) and the Federal Trade Commission (FTC). The primary regulatory burden in M&A transactions exceeding relatively low thresholds for transaction value and size of transaction participants is providing prior notice of the transaction to the DOJ and FTC. The parties may not close the transaction until the expiration or termination of post-notice waiting periods, during which the regulators may request additional information or challenge the transaction. While rare, expiration of the waiting period does not foreclose a governmental challenge post-closing.

Review of Transactions Involving Foreign Investment for National Security Concerns

The Committee on Foreign Investment in the U.S. (CFIUS) has broad authority to review certain transactions that involve foreign investment. While notifying CFUIS of transactions is voluntary, because CFIUS has the power to recommend changes or rescission of completed transactions, customary practice is to notify CFIUS in advance in transactions involving sensitive foreign investors or targets that present heightened risk, such as those with significant government contracting, operations relevant to national security, advanced technologies or export controlled goods and services.

State law may affect M&A transactions, including with respect to fiduciary duties, shareholder rights and the transaction's structural requirements. Transactions involving targets in regulated industries or operations may have additional regulatory oversight.

4. Due Diligence

4.1 General Information

Legal advisors representing private equity acquirers generally conduct a thorough due diligence investigation of target companies. These investigations involve reviewing materials provided by the target or an investment banker who facilitates information and document requests and is the primary point of contact for legal and other advisors.

The scope of the legal due diligence review is broad and typically includes detailed examinations of targets' equity ownership and capitalisation, formation and organisational documents, equity holder arrangements, material contracts with customers, suppliers and other key relationships, employment agreements, financial statements, and records related to tax, real property, intellectual property, environmental investigations, legal compliance, litigation, employees and employee benefits.

In addition to a review of materials provided by the target and its representatives, advisors typically search publicly available lien, litigation and bankruptcy filings in jurisdictions relevant to the target's operations and interview target management for clarification of key issues. Among other important matters, legal advisors seek to identify any obstacles to completing a transaction, including required consents or notices (third-party, equity holder or governmental) and restrictions that may impact the private equity sponsor's valuation of the target, such as non-competition, most-favoured nation pricing, exclusivity or non-solicitation provisions. Increasingly, legal due diligence investigations focus on matters receiving heightened governmental and media scrutiny, such as anti-corruption compliance, data privacy and sexual misconduct.

The increasing use of R&W insurance in private equity sponsored acquisitions has resulted in the production of more formal due diligence work product authored by advisors and their subject matter experts and heightened focus on conducting a comprehensive and thorough due diligence investigation. Prior to issuing a policy, the R&W insurance underwriter typically conducts its own independent legal due diligence investigation, reviews the due diligence reports prepared by the buyer's legal and other advisors and conducts detailed interviews with those advisors on the content of their reports and the scope of their investigation.

4.2 Vendor Due Diligence

Historically, private equity buyers in US buy-out acquisitions have not relied on vendor due diligence reports. Increasingly, sellers conduct due diligence on select matters that they anticipate may be areas of focus in a buyer's due diligence review and provide vendor due diligence reports to bidders in an effort to control the messaging of potential concerns and head off renegotiation of economics and other key deal terms after a winning bidder is selected in an auction process. However, buyers typically rely on their own review of those matters, and definitive transaction agreements typically eliminate the buyers' legal recourse for materials not expressly included in the agreement's representations and warranties.

5. Structure of Transactions

5.1 Structure of the Acquisition

Most US private equity sponsored buy-out acquisitions are structured as privately negotiated agreements, taking the form of a purchase and sale of equity or assets, or a merger.

Purchase and sale transactions are used where the seller is a single owner or a small, controlled group of equity holders. Transactions are customarily structured as mergers (which typically require approval from less than all equity holders) where broader groups of equity holders exist or where potential recalcitrance of minority equity holders might delay or block a traditional purchase and sale transaction.

Merger structures are occasionally employed to limit post-closing seller liability in the transaction, with the target company being the sole non-buyer party to the merger agreement and recourse to equity holders of the target limited or non-existent.

Courts rarely participate in acquisition transactions, other than in US federal bankruptcy cases. In those cases, private equity buyers (often specialised distressed asset funds) may acquire the equity or assets of a bankrupt debtor following a court-supervised marketing process, with the transaction agreements privately negotiated by the debtor (or a trustee) and the buyer and approved by the bankruptcy court following one or more hearings.

In 'take-private transactions' (see **7.1 Public to Privates**, below), private equity sponsored acquisitions may also utilise public tender offers, typically followed by mergers.

In the current seller-friendly market, most transactions result from broadly marketed auction processes, but private equity buyers continue to devote significant energy to identifying so-called 'proprietary' targets where buyer and seller negotiate the transaction without a competitive process. Auctions tend to result in more favourable seller outcomes in both economics and legal terms, but they require dedication of target management resources over a lengthy marketing and auction period. Transactions involving smaller targets or those with limited potential buyers based on industry, regulatory or other considerations often result from proprietary negotiations.

5.2 Structure of the Buyer
Private equity sponsored buy-out transactions (other than add-on transactions by existing portfolio platforms) typically involve a special purpose buyer entity formed and funded by the private equity fund shortly before the acquisition. Co-investor, employee and seller-reinvested equity financing is typically invested in this buyer entity rather than directly in the target.

Frequently, unaffiliated co-investors invest in the buyer indirectly through additional upstream special purpose entities controlled by the private equity fund. This structure is intended to limit the private equity fund's contractual exposure in the acquisition, both under the primary acquisition agreements (where upstream fund-level guarantees are typically non-existent or limited to narrow, specific areas, such as reverse termination fees) and the debt-financing arrangements (where lenders typically require guarantees from the buyer entity but not the fund). The structure enhances flexibility in exit options where co-investor or employee investments exist, allowing the private equity fund to control seller conduct directly without having to enforce contractual remedies under drag-along agreements. Minority investments by private equity funds typically employ a similar special purpose entity.

5.3 Funding Structure of Private Equity Transactions
Private equity acquisitions are almost universally financed with a mix of equity and debt. While debt financing levels typical of the leveraged buy-out eras of the 1980s and 2000s have not been prevalent in the market to any comparable extent since the 2008 credit crisis, most private equity sponsored buy-outs are financed with significant levels of debt, with some form of borrowed money often representing half or more of the acquisition financing.

Private equity sponsors typically employ senior secured term debt as a primary source of debt financing, but mezzanine debt may be used where sufficient senior credit is not available. Banks remain the preferred lenders in private equity sponsored acquisitions, but increasingly debt funds and other non-traditional lenders provide primary senior debt financing rather than only mezzanine and other subordinated lending.

The majority of the equity in a private equity buy-out is typically provided by the private equity sponsor. Minority equity investments by private equity funds are less common. The private equity sponsor typically provides an equity commitment letter in transactions structured with a separate signing and closing.

5.4 Multiple Investors
'Club deals', where multiple private equity funds form a consortium to bid jointly for a target, have fallen out of popularity over the last two decades, a trend driven by anti-competition concerns from regulators and sellers seeking more robust auctions. Additionally, club deals pose challenges in negotiating deal terms on increasingly accelerated time frames in the current seller-friendly market, and they create post-acquisition governance issues. However, club deals have seen a modest comeback in recent years as private equity funds look for broader opportunities to deploy high levels of dry powder.

Co-investors are frequently included in private equity sponsored transactions and their prevalence has increased modestly during recent years as funds search for more flexibility in obtaining equity financing without overly concentrating a portfolio, and investors seek to employ funds without customary fees and carried interest allocations.

Co-investments arise from a variety of sources: so-called 'rollover' equity reinvested in the restructured target by existing selling equity holders, direct investments by the private equity fund's limited partners, cash investments by management of the target and additional equity financing from the lenders of debt financing.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms
The purchase price in a typical US private equity sponsored acquisition is generally a base purchase (typically reflecting the enterprise value of the target), reduced by certain amounts at closing – including indebtedness of the target and transaction expenses incurred by the target (often paid in full by the buyer at closing) – and adjusted for variations in working capital or other closing accounts at closing from a negotiated target amount.

Closing account adjustments are typically estimated shortly before closing and finalised an agreed period of time after closing (typically 30-120 days) based on actual closing account values reflected in financial reports prepared by the buyer. Disputes over working capital adjustments are customarily resolved by an agreed-upon neutral third party.

A portion of the purchase price is sometimes contingent upon satisfaction of certain specified post-closing conditions, often revenue or profit targets. The terms of these so-called 'earn-out' payments are typically used to bridge valuation gaps and are heavily negotiated, particularly with respect to the conditions, the standards used to measure their satisfaction, and conduct of the business post-closing to the extent it may affect achievement of the earn-out conditions. Earn-out payments are more common in transactions with private equity buyers than with private equity sellers. Earn-out payments are frequently the subject of post-closing disputes that are typically required to be resolved by a neutral third party similar to disputes over closing account adjustments.

Sellers' payment obligations in connection with closing account adjustments are frequently secured by a portion of the purchase price held in escrow pending post-closing resolution of the closing account values. By contrast, buyers' closing account adjustment payment obligations are rarely secured by escrowed amounts. It is not uncommon for a seller to negotiate for the adjustment escrow to be a buyer's exclusive recourse for negative purchase price adjustments, often in exchange for a matching collar on positive adjustments.

6.2 Locked Box Consideration Structures

Locked box consideration mechanisms are rare in US private equity sponsored acquisitions, other than in the context of cross-border transactions with sellers in jurisdictions where such mechanisms are more prevalent. However, if the recent seller-friendly M&A market conditions persist in the USA, locked box structures could increase in popularity as sellers exploit their relatively strong bargaining position and prospective buyers seek to enhance their bid values in competitive auctions.

6.3 Dispute Resolution for Consideration Structures

Disputes between the parties regarding the closing account purchase price adjustments are typically submitted for binding resolution to a neutral third party, often a financial accounting or audit firm. This generally follows a specified period of negotiation among the parties.

6.4 Conditionality in Acquisition Documentation

While conditions to the buyer's obligation to close an acquisition are typically negotiated based on specific characteristics of the transaction and the target, some variants of the following key closing conditions are customary:

- required regulatory approvals have been obtained or satisfied, including approval or the expiration of applicable waiting periods under the HSR Act;
- shareholder approval (in the case of a merger or a sale of substantially all assets) has been obtained;
- the representations and warranties of the target and seller(s) are true and correct as of the closing, and the target and seller(s) have performed their pre-closing covenants;
- no litigation or other proceeding exists that prevents the closing;
- specifically identified required third-party consents or notices have been given (typically these are limited to material contracts);
- pay-off letters and lien release authorisations have been obtained from lenders that will be repaid at closing.

Private equity buyers often negotiate for a condition that no 'material adverse effect' has occurred between signing and closing. Other transaction-specific conditions are frequently negotiated, including delivery of new restrictive covenant or employment agreements, effectiveness of ancillary transactions occurring simultaneously and satisfactory remediation of material matters uncovered in due diligence. Financing and due diligence conditions are rare except in very buyer-favourable circumstances.

6.5 'Hell or High Water' Undertakings

Private equity buyers traditionally resisted so-called 'hell or high water' covenants, which require the buyer to take all actions necessary to obtain applicable regulatory approval of the transaction, including – in the case of clearance under the HSR Act – commencing litigation, divesting assets or agreeing to restrict other business operations. This is particularly sensitive to private equity funds with diverse holdings where anti-trust scrutiny of the transaction could trigger obligations under these covenants that would adversely affect the fund's other portfolio investments. However, the recent seller-friendly M&A market has seen private equity buyers soften their opposition to some forms of hell or high water covenants, particularly where little anti-trust risk is foreseeable

6.6 Break Fees

In transactions where the acquisition agreement provides a private equity buyer the right to terminate the acquisition agreement for its failure to obtain debt financing (see **6.7 Termination Rights in Acquisition Documentation**, below), upon the buyer's exercise of the termination right, the buyer is typically required to pay a reverse termination fee (customarily between 2% and 7% of the base purchase price, depending on the transaction size) as the target's and the seller's exclusive remedy for the buyer's failure to close. Otherwise, termination fees are uncommon in private equity sponsored acquisitions, except in transactions with public company targets.

6.7 Termination Rights in Acquisition Documentation

A typical acquisition agreement may be terminated before closing by a private equity seller or buyer under limited circumstances, including where the closing has not occurred before a specified outside date, or the counterparty fails to cure its material breach of the agreement.

In transactions funded by significant acquisition debt financing, private equity buyers often negotiate the right to terminate the acquisition agreement if adequate debt financing is not secured by a specified date in exchange for payment of a reverse termination fee (described in **6.6 Break Fees**, above). In this approach, the buyer customarily makes representations regarding debt financing commitments obtained at signing and is typically bound by covenants to use reasonable efforts to secure the financing.

6.8 Allocation of Risk

Allocation of risk is primarily governed by a negotiated package of indemnities provided by the seller. General indemnities typically cover losses suffered by the buyer as a result of any inaccuracy or breach of the representations and warranties made by the seller or the target in the acquisition agreement. In addition, narrowly tailored specific indemnities may cover known concerns identified in the due diligence process.

Bolstered by the availability of R&W insurance policies, sellers, particularly private equity sellers, increasingly seek to minimise post-closing liabilities by negotiating for limited or virtually no post-closing liability. This 'public company style' allocation of liability results in structures with minimal or no significant post-closing seller liability that rely almost exclusively on R&W insurance to manage buyer risk.

6.9 Warranty Protection

In a traditional private equity transaction, the seller is responsible for the representations and warranties related to the target (whether made by the seller itself or made by the target and backstopped by the seller through indemnity). While the target's management is typically involved in reviewing the representations and warranties and preparing disclosure schedules, it is rare that management is a party to or bears any contractual liability under the acquisition agreement, other than to the extent of management's equity holdings.

Limitations on a seller's liability for representations and warranties typically depend on both the nature of the representations and warranties and whether the transaction involves R&W insurance or another recourse-limiting feature. Broadly speaking, representations and warranties are classified (for liability limitation purposes) as either 'fundamental' or 'non-fundamental' based on their subject matter and the extent to which they are critical to the essence and validity of the transaction. Seller liability for the handful of fundamental representations and warranties survives closing for a relatively long time (often 20 years or more, where permitted by applicable state law) and is typically capped at the purchase price. By contrast, seller liability for non-fundamental representations and warranties typically survives for only 12 to 24 months and is capped at a small percentage of the purchase price (usually 10% or less, and as little as 0% to 1% in R&W insurance transactions).

Indemnification for non-fundamental representations and warranties is ordinarily subject to a deductible (of up to 1% of the purchase price) borne by the buyer and often an exclusion of de minimis losses below a small threshold. Some representations and warranties defy the broad fundamental/non-fundamental classification. For example, representations and warranties related to taxes of the target often feature an intermediate survival period tied to the tax statute of limitations and liability capped at the purchase price. Those related to environmental or employee benefit matters may have longer survival periods or not be subject to deductibles and other indemnification limits.

The custom in US private target transactions is to limit legal reliance of all parties to the four corners of the acquisition agreement. Accordingly, the acquisition agreement precludes reliance by the buyer on representations and warranties outside of those expressly included in the agreement, and similarly limits exceptions to those representations and warranties to matters expressly identified in disclosure schedules to the acquisition agreement delivered by the seller or the target. Materials made available in data rooms or otherwise may not be relied on by either party in connection with liability issues, except to the extent expressly incorporated into the acquisition agreement.

6.10 Other Protections in Acquisition Documentation

A portion of the purchase price in a private equity transaction is typically deposited in escrow to backstop the seller's indemnity obligations. While traditionally a buyer would have direct recourse to the seller for at least a portion of the indemnity obligations in excess of the indemnity escrow, it has become increasingly common for the indemnity escrow to serve as the exclusive source of a buyer's recovery, with limited exceptions for breach of fundamental representations and warranties, taxes, breach of covenants and perhaps an indemnity unique to the transaction. Escrow holding periods typically match the general survival period for a seller's liability for non-fundamental representations and warranties (12-24 months).

The use of R&W insurance in private M&A transactions involving private equity funds has increased dramatically in recent years. That increase has enhanced the viability of transactions that significantly limit seller liability for representations and warranties. Indemnity escrows that customarily ranged between 5% to 10% of purchase price before the advent of R&W insurance typically drop to between 0.5% to 1% in R&W insurance transactions, and occasionally buyers agree to eliminate the indemnity escrow in aggressively seller-favourable transactions with R&W insurance.

Seller liability in R&W insurance transactions varies widely as available insurance products allow buyers to customise risk allocation to deal-specific demands and the competitive contours of the auction process. The current trend is moving toward further limiting seller liability. Despite the rapid rise in popularity of R&W insurance in private M&A transactions, experience on the claim resolution process under those policies is limited. Consequently, it remains to be seen how effective R&W insurance is in practice as an effective substitute for direct recourse against the seller.

6.11 Commonly Litigated Provisions

Litigation over post-closing disputes in private equity transactions is rare, in part because private equity funds often resist litigation due to reputational risk. Accordingly, private arbitration is popular among private equity participants in M&A transactions. Post-closing disputes commonly arise in connection with closing account adjustments. These disputes are ordinarily resolved by private negotiation or by a neutral third party.

Earn-out payments are another area of frequent dispute, as they often call for a closing-account type of reconciliation for determining the earn-out payments on a frequent, repeated basis, potentially over several years. Tax and environmental liability are additional areas of common seller liability, but these issues are typically identified before closing through careful due diligence and are the subjects of specific indemnities (frequently with special escrows), minimising dispute over coverage post-closing.

7. Takeovers

7.1 Public to Privates

Public-to-private or 'take-private' transactions represent a modest portion of the overall volume of US private-equity funded transactions. However, private equity firms continue to raise and deploy record-setting amounts of capital, which has resulted in a recent significant increase in public-to-private acquisitions after several years of relatively flat volume following the 2008 recession.

7.2 Material Shareholding Thresholds

Shareholding disclosure thresholds and filing requirements are defined in the Securities Exchange Act of 1934, which provides as follows.

- Any party (or parties acting together) acquiring more than 5% of a class of voting equity securities of a US public company must file a publicly available Schedule 13D or 13G with the Securities and Exchange Commission (SEC). Schedule 13D, the document required of potential acquirers, is due within ten calendar days of crossing the 5% threshold and must be promptly amended following certain changes. Among other things, Schedule 13D discloses the acquirer's identity, purpose for the investment, securities beneficially owned and consideration paid for the securities.
- A party engaging in a take-private transaction of a public company that is an 'affiliate' of such company must file a Schedule 13E-3 prior to undertaking a tender or exchange offer or merger. Schedule 13E-3 requires, among other things, disclosure of the purpose and effects of the transaction and why the filing party believes the transaction is fair to the shareholders of the public company. Determination of whether a party is an 'affiliate' of a public company depends on the specific facts and circumstances, although a general rule of thumb is that an owner of 10% of the company who has the right to appoint one or more directors to the company's board is presumed to be an affiliate for this purpose.

In addition, the HSR Act generally requires that any acquisition of voting securities, non-corporate interests or assets in excess of certain thresholds (USD90 million as of 2019) be reported to the DOJ and the FTC prior to any such acquisition. Thereafter, the acquisition cannot be completed before the applicable waiting period (30 calendar days for most transactions) either expires or is terminated earlier, upon request by the filing parties granted at the discretion of the regulatory agencies. The agencies may also extend the review period by requesting that additional information and materials be submitted.

7.3 Mandatory Offer Thresholds

US federal securities laws do not require bidders acquiring a significant portion of a public company's shares make mandatory offers to acquire additional shares from the company's other shareholders. However, the laws of three US states (Maine, Pennsylvania and South Dakota) include 'control share cash-out' provisions permitting shareholders of corporations incorporated in such states to demand that bidders acquiring more than a specified percentage of shares (as low as 20% in Pennsylvania) purchase their shares at a specified price (for example, the highest price paid per share by the bidder in recent share acquisitions).

7.4 Consideration

Cash is the more often used form of consideration to acquire US target companies. Issuance of shares may require registration of the offering with the SEC, an expensive and time-consuming process. However, if structured in accordance with applicable provisions of the US Internal Revenue Code of 1986, as amended, a transaction involving the exchange of target company stock for acquirer stock may qualify, in whole or in part, as a tax-free reorganisation under which the receipt of the acquirer stock by the target company's shareholders would not be taxable.

7.5 Conditions in Takeovers

Acquisitions of US public companies are typically effected pursuant to merger agreements, under which either (i) the public company's board of directors and shareholders approve a one-step merger under applicable state law or (ii) the acquirer first makes a public tender or exchange offer soliciting shareholders to sell their shares for the proposed consideration (cash in the case of a tender offer or securities, alone or in addition to cash in the case of an exchange offer), and second acquires the remainder of the target company's shares through a statutory second-step or 'squeeze-out' merger.

Bidders may make takeover offers subject to the satisfaction of specified conditions, which typically include the following.

- Regulatory approval, including necessary anti-trust approvals under the HSR Act, as well as other regulatory approvals that may be implicated by the transaction or the nature of the acquirer. If the acquirer is a non-US person, a voluntary submission to the Committee on Foreign Investments in the United States (CFIUS) may be advisable to eliminate the risk of the transaction being unwound later.
- The absence of any change, event or circumstance that has had or is reasonably likely to have a material adverse effect on the target company.
- The target company complying with representations, warranties and covenants in the merger agreement.
- If the offer includes a tender or exchange offer, tender by shareholders of a minimum number of target company shares (often the number required to approve or complete a second-step merger).
- Requisite shareholder approval.

Transactions may be conditioned on the acquirer obtaining adequate equity and/or debt financing. When such a condition is accepted, target companies typically require that the acquirer has binding commitments from its financing sources at the time the merger agreement is signed and also require a 'reverse termination fee' payable by the acquirer. That fee is typically the target company's sole recourse if such financing is not funded.

The target company often agrees to pay a termination or 'break-up' fee to the acquirer if the merger agreement is terminated in certain circumstances, such as:

- requisite shareholder approval not being obtained when a competing offer from another potential acquirer exists;
- the target company entering into an agreement with another acquirer within a specified period of time after termination of the merger agreement.

The merger agreement typically governs the target company's ability to solicit or support competing offers and must accommodate the directors' fiduciary duties to the target company's shareholders under applicable state laws in this situation. Provisions may range from permissive ('go shop') to restrictive ('no shop'). The merger agreement may provide the acquirer 'matching rights' or a 'last look' allowing it to match superior third-party bids received by the target company. Although less common recently, the acquirer may seek a 'force the vote' provision requiring the target company's board to present the transaction to a shareholder vote, even if the board withdraws its support of the transaction.

7.6 Acquiring Less Than 100%

If a bidder has acquired the requisite shares to approve a statutory merger under applicable state law and the target company's organisational documents, the bidder can effect a second-step or 'squeeze-out' merger to acquire the target company's remaining shares.

State laws typically require that mergers be approved at a meeting of the company's shareholders, unless (i) the target company's organisational documents permit mergers to be approved by written consent of the shareholders, or (ii) the bidder has acquired the statutorily required number of shares to effect a short-form merger, which permits an expedited process without a shareholders meeting.

Most state laws require that the bidder hold 90% of the outstanding shares to effect a short-form merger. However, some state laws (including Delaware) permit bidders to complete short-form mergers following first-step tender offers in which enough shares are acquired to approve a merger under the target company's organisational documents (which may, for example, be a simple majority of the outstanding shares).

If a bidder does not seek or obtain 100% of the target company's shares, it may nevertheless obtain significant governance control with respect to the target company. A bidder acquiring the requisite shares required under applicable state law and the target company's organisational documents to elect directors (typically a plurality of the votes cast) may nominate and elect all directors, although for companies with staggered director terms, electing all directors may require several years. Significant share ownership may provide a bidder with blocking rights on matters submitted to shareholders and permit the bidder to seek negotiated rights.

7.7 Irrevocable Commitments

Potential acquirers often seek 'lock-up' agreements from principal shareholders of the target company to tender their shares or vote in favour of the merger. Such agreements are typically entered into simultaneously with the signing of the merger agreement.

As a matter of Delaware law, restrictions imposed under such tender or voting agreements, together with the obligations of the company's directors under the terms of the merger agreement, may not be so broad as to impede the directors' ability to exercise applicable fiduciary duties and entirely preclude the company from pursuing a better offer from a competing bidder. Depending on circumstances, lock-up agreements also may be subject to restrictions under SEC regulations.

7.8 Hostile Takeover Offers

Hostile takeovers are permissible in the USA, although they are far less common than friendly takeovers and face significant hurdles. State statutes permit corporations to implement takeover defences such as shareholder rights plans ('poison pills') and staggered terms for directors to deter potential hostile acquirers.

Poison pills are triggered when an acquirer accumulates a certain percentage of the target company's outstanding shares and threaten substantial dilution to the acquirer and a significantly higher acquisition cost. Under staggered board terms, only a minority of the total number of the company's directors (typically one-third) are re-elected or replaced in a single year.

In addition to the challenges presented by takeover defences, hostile acquisitions typically take longer to complete than negotiated transactions, impose higher acquisition costs that may include litigation, and limit the bidder's ability to conduct robust due diligence with the co-operation of the target company's board and management.

Hostile acquisitions may present potential reputational risks to the bidder, especially when the attempted takeover is ultimately unsuccessful or the target company engages in a negative publicity campaign against the bidder. Private equity buyers seldom pursue hostile takeovers and often agree with their investors not to make investments other than on a friendly basis.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Private equity sponsors commonly rely to a significant degree on equity to align incentives of management with those of the sponsor. Management equity may arise from reinvestment of target company stock ('rollover' equity), cash investment in the post-closing company, or incentives issued to key management members in connection with or after the transaction closing.

The magnitude of management equity participation varies widely based on the private equity fund's philosophy and the extent of management investment in the pre-acquisition target. The amount of rollover equity investment is particularly transaction-specific, typically the subject of negotiation between management sellers and the private equity sponsor and often driven in part by tax considerations.

Private equity sponsors commonly seek to retain, rather than replace, existing management teams and therefore wish to maintain management's commitment to the post-closing business. Accordingly, private equity buyers often permit a target's management to make significant investments in the acquiring company (from 10% to as much as 50% of the transaction's equity financing) through rollover equity or new investment.

The scale of incentive equity in the post-acquisition equity capitalisation is, by contrast, somewhat more uniform in private equity transactions. Historically, incentive equity commonly represented around 10% of a private equity sponsored company's fully diluted equity, but more recently incentive equity pools have increased to approach 15% and sometimes greater, particularly in smaller companies. In step with this trend, private equity sponsors may rely on more aggressive performance thresholds for incentive equity participation.

The breadth of participation in incentive equity programmes varies by industry and investment size. Typically, incentive equity participation is limited to 'C-level' management and other key employees. However, in certain industries, such as technology and life sciences, broader incentive equity participation among less-senior employees is more common and often a necessity to attract and retain skilled employees in tight labour markets. Larger investment sizes generally correspond to broader incentive equity participation.

8.2 Management Participation

The nature of rollover equity has changed over time. While historically it was common for rollover equity to be subordinated to preferred equity issued to a private equity sponsor, rollover equity is now more typically pari passu with the sponsor's equity, at least in terms of liquidation preferences, participation rights and other economic terms. Despite economic parity, the private equity sponsor typically retains broad, exclusive control over matters such as governance, additional equity financing and liquidity.

Incentive equity in private equity investments takes many forms, including profits interests, stock options, phantom equity, stock appreciation rights and restricted stock. Stock options and profits interests are the most common forms and share similar mechanics, permitting management to participate in equity value above the value at the time of issuance.

However, the generally employee-favourable tax treatment of profits interests (typically permitting capital gains treatment on liquidity, while proceeds from stock options are taxed as ordinary income rates in most circumstances), together with the increased popularity of limited liability company structures in private equity investments (for most practical purposes, the use of profits interests is limited to limited liability companies), has led to a marked trend toward profits interests over stock options in recent years. The prevalence of stock options persists in certain industries (including software and other technology sectors).

Restricted stock and similar types of capital equity are less commonly used for incentive equity, and usage is limited to corporations. Unlike stock options or profits interests, the value of restricted stock is taxable to the recipient at issuance. Accordingly, unless the recipient pays fair market value in exchange for the equity, the employee would have an upfront tax obligation without any corresponding liquidity until an exit scenario.

To avoid this tax timing dilemma, the issuer company can loan the fair market value of the restricted stock to the employee to finance the employee's purchase of the stock. The terms of those loans are subject to rules of taxing authorities and as a result must not be entirely non-recourse. They are generally repaid in connection with liquidation of the stock or termination of the employee's employment relationship.

8.3 Vesting/Leaver Provisions

Vesting of management equity differs based on the type of equity. Typically, rollover equity and cash investments by management are fully vested upon issuance, as is the equity purchased by other investors. Incentive equity, however, is customarily subject to vesting requirements, with vesting commonly occurring incrementally over periods of three to five years. The frequency of incremental vesting varies, commonly annually or monthly, sometimes with 'cliff' vesting of a larger portion after the first vesting period, followed by a straight-line vesting schedule of the remainder. Incentive equity may also be subject to performance vesting conditions, commonly tied to a multiple of the private equity sponsor's return on invested capital. Vesting determines the treatment of incentive equity upon termination of the employee's employment. Incentive equity that is vested at termination is typically owned by the terminated employee (often subject to repurchase by the company at fair market value), while unvested equity is typically cancelled or otherwise surrendered without consideration. Time-based vesting of incentive equity is often accelerated in connection with certain specified liquidity events, and less commonly in connection with termination of the employee's employment by the company without cause or by the employee for good reason.

Management equity is typically subject to being repurchased following certain events. Repurchase rights are typically broader (and less favourable to the employee) for incentive equity, and narrower (and more favourable to the employee) for rollover equity or cash investments. The amount the company is required to pay to exercise repurchase rights also typically differs between incentive equity and rollover equity or cash investments. The repurchase price is typically the fair market value of the equity, but if the employee's employment is terminated by the company with cause or by the employee without good reason, then the repurchase price for incentive equity may be some nominal amount (or no amount). These 'good leaver/bad leaver' provisions occasionally apply to management rollover equity or cash investments, but it is more common for that equity to be repurchased at fair market value in all circumstances. Repurchase rights are typically permissive, rather than mandatory, and management put rights are uncommon in private equity sponsored companies.

8.4 Restrictions on Manager Shareholders

Private equity sponsors typically seek restrictive covenants from management shareholders, either in the definitive acquisition agreement, in a securities purchase agreement or in a separate restrictive covenant agreement for continuing management. Typically, these restrictive covenants include non-competition, non-solicitation (of employees, customers and other business relationships) and no-hire restrictions, as well as non-disparagement, non-interference and confidentiality covenants. The term and scope of these obligations are subject to negotiation and vary across transactions, but five-year terms that cover the entire world are not uncommon in merger and acquisition transactions involving businesses with a material international presence.

The enforceability of restrictive covenants (including specific, often technical, requirements for enforcement) varies from state to state within the USA and depend on the consideration given for the agreements. While most jurisdictions enforce non-competition and non-solicitation restrictions on selling shareholders in the context of merger and acquisition transactions, enforceability is less certain in many US states in ordinary employment relationships (and in some states are unenforceable). Even in the context of merger and acquisition transactions, states enforce non-competition and non-solicitation restrictions only to the extent that they are reasonably limited in duration and scope to the extent necessary to protect the goodwill and business of the acquired company.

8.5 Minority Protection for Manager Shareholders

Management equity generally represents a minority position in the post-acquisition equity capitalisation. Incentive equity holders commonly have little or no rights outside of their economic rights. Holders of equity obtained by purchase (including rollover equity and cash investments) typically have minority protections that fall into four categories: anti-dilution, exit participation, restrictions on sponsor-affiliate transactions and information rights.

Anti-dilution

The anti-dilution rights of management equity holders typically take the form of participation (or pre-emption) rights to subscribe for additional equity issuances to maintain their proportionate equity position. In private equity sponsored companies, participation rights often apply only to issuances to the private equity sponsor or its affiliates, permitting the sponsor to dilute the management minority equity holders to the same extent that the sponsor dilutes itself through third-party equity financing. Less commonly, participation rights apply to a broader array of equity financing.

Exit Participation

Exit participation rights of management equity holders are designed to prevent a private equity sponsor from exiting its investment without providing liquidity to management and other minority investors. The rights typically are provided as so-called 'tag-along' rights, which permit minority holders to sell their equity on a pro rata basis (described in more detail in **10.3 Tag Rights**, below). Additionally, registration rights agreements often provide minority investors the right to participate in registration of public securities for resale, although these agreements have become less relevant in recent years as public offerings of securities in private equity sponsored companies is less common.

Restrictions on Sponsor-affiliate Transactions

Minority investors may negotiate restrictions on proposed transactions between the private equity sponsor or its affiliates and the company. These rights are aimed at preventing the sponsor from using its control of the company to extract value that the minority would otherwise be entitled to by virtue of its equity position.

Information Rights

Minority investors typically receive limited information rights, often including periodic financial statements but occasionally broader rights. Because management would typically have access to that information (at least while employed by the company), minority information rights often are of limited value to management equity holders.

Occasionally, management and other minority investors with significant capital equity positions negotiate rights to appoint board members. Private equity sponsors rarely surrender control of the governing board. Likewise, minority investors in a private equity sponsored company rarely have veto rights over company action. Minority investors usually are subject to a series of restrictive provisions, including the private equity sponsor's 'drag-along' rights (described in **10.2 Drag Rights**, below), strict restrictions on transfer of equity, and rights of first refusal in favour of the company and the private equity sponsor on most transfers of equity. The result of these limited rights and broad restrictions is that the sponsor has nearly absolute control over operations, financing, acquisitions and liquidity.

In most US states, including Delaware, statutory-provided minority rights are limited, and in limited liability companies minority rights are almost entirely left to contract provisions.

9. Portfolio Company Oversight

9.1 Shareholder Control

Private equity sponsors typically enjoy broad control rights over portfolio investments in which they hold a majority interest, ordinarily controlling appointment of at least a majority (and often all) of the governing board and rarely ceding much if any control to minority holders, except in the context of limited minority protections (described in **8.5 Minority Protection for Manager Shareholders**, above). Accordingly, private equity sponsors commonly have legal control of all operational, capital and liquidity matters, although as a practical matter they frequently defer to a significant extent to existing management in operational matters.

In the context of minority private equity investments, the fund often negotiates for specific veto rights, including with respect to exit transactions, additional equity, material deviations from approved budgets and enhanced information rights. Control rights in these minority investment contexts vary broadly depending on the size of the investment, the parties involved, and the fund's investment strategy.

9.2 Shareholder Liability

Private equity funds that hold controlling equity positions in a portfolio investment may be liable for the portfolio company's conduct in certain circumstances. For example, majority equity holders may be liable for the company's employee pension obligations under the U.S. Employee Retirement Income Security Act of 1974 (ERISA), the company's compliance with various environmental regulations, or for the company's failure to comply with requirements of the Worker Adjustment and Retraining Notification Act of 1988 (WARN) and state labour regulations. Law enforcement bodies have increasingly brought or threatened action against controlling equity holders for the criminal conduct of operating companies, including under the federal False Claims Act and the Foreign Corrupt Practices Act (FCPA), typically in situations where heightened levels of operational control are exercised.

Civil liability may also pass to controlling private equity funds in scenarios where lack of required corporate formalities and other bad acts can result in limited liability structures being disregarded under corporate veil piercing and other alter ego theories. Private equity funds can minimise the risk of exposure to portfolio company liability by observing traditional corporate formalities, installing formal governance bodies at portfolio companies separate from those of the fund, documenting thorough due diligence of potential criminal conduct before the acquisition and regularly exercising diligent oversight of the company's conduct after the acquisition.

9.3 Shareholder Compliance Policy
In an effort to insulate private equity funds from control liability (described in **9.2 Shareholder Liability**, above), as well as to enhance exit value and avoid reputational losses, controlling private equity sponsors commonly will insist that their portfolio companies adhere to robust legal compliance policies, including with respect to anti-corruption under the FCPA and state laws, compliance with employee benefits requirements under ERISA, and increasingly policies addressing sexual misconduct. This oversight often involves regularly auditing policy compliance, but it is balanced with a concern that a fund's exercise of too much control over day-to-day compliance may actually enhance the risk of control liability generally.

10. Exits

10.1 Types of Exit
Average holding periods for private equity investments have increased over the recent decade, replacing the traditional three to five-year period historically characterising those investments with average periods exceeding six years in recent years. This may be driven in part by a stagnant IPO market and increased popularity of funds with long-term investment horizons focused on minimising transaction costs and other inefficiencies incident to shorter investments.

The most common exit for a private equity investment is a complete liquidation in a buy-out transaction. Only in extraordinary circumstances will private equity funds reinvest in an exit transaction; the terms of the fund generally dictate that the fund be wound up before a reinvested investment is likely to be liquidated.

Bartlit Beck LLP

1801 Wewatta Street, Suite 1200
Denver, Colorado 80202

BartlitBeck LLP

Tel: (303) 592-3100
Fax: (303) 592-3140
Email: benjamin.smith@bartlitbeck.com
Web: www.bartlitbeck.com

10.2 Drag Rights
Private equity sponsors holding a controlling equity position typically enjoy broad rights to compel the sale of minority equity positions in connection with the majority's exit. These 'drag-along' rights usually apply to all minority investors, including institutional co-investors, although the specific terms of the drag rights may be negotiated individually. Drag-along rights are commonly triggered by the sale of a controlling stake in the company, but occasionally apply to smaller transfers, such as sale of a majority of the controlling equity holder's position. Drag-along rights are seldom exercised. Buyers are typically sensitive to minority dissent in a transaction and reticent to close an acquisition unless each equity holder is a party to the acquisition agreement. More often, an alternative transaction structure (such as a merger or asset sale) is employed to avoid minority holdup value or refusal to deal. Accordingly, drag-along rights have more value in establishing the expectations of the parties and creating a mostly symbolic threat than in practice.

10.3 Tag Rights
Management and other minority investors typically have rights to participate (on a basis proportionate to their respective investment positions) in a complete or partial exit led by the majority private equity sponsor. These 'tag-along' rights are commonly triggered by any sale of equity (other than specified permitted transfers such as transfers to affiliates and estate planning transfers), but thresholds may be negotiated to permit partial exits without minority participation, as when a sponsor has a plan to sell down equity to co-investors. Tag-along rights usually require the sponsor seller to use some level of reasonable or best efforts to facilitate participation in the transaction by the tag-along investors, and the sponsor may not complete the exit if the prospective buyer refuses tag-along investor participation.

10.4 IPO
In general, IPOs remain rare in the USA, particularly among private equity sponsored companies. Lock-up periods applicable to private equity and other pre-IPO equity holders are typically 90-180 days. Relationship agreements are not a common feature of US IPOs.