THE INTERNATIONAL COMPARATIVE LEGAL GUIDE TO: PRIVATE EQUITY 2021

7TH EDITION

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions?

The most common types of private equity ("PE") transactions in the UK centre around leveraged buyouts (in the form of share and asset acquisitions), take-private transactions, flotations and bolt-on transactions. Accompanying a majority of these transactions will also be the leveraged financing/refinancing of such deals from a variety of debt sources.

Based on the British Venture Capital Association ("BVCA"), the value of PE investments in the UK went up from £22.2 billion in FY 2017 to £25.1 billion in FY 2020. With the backdrop of Brexit and the uncertainty of the COVID-19 pandemic, the PE market fell away sharply during the latter part of H1 2020. The impact on market activity was significant, with announced PE exits dropping 70% in May 2020 *versus* May 2019. However, just as sharply as it fell away, PE dealmaking returned during H2 2020 with vigour and with higher asset valuations than had been seen previously, reflecting investors' demands for returns in a low-yield environment. The PE market continues to perform well, outpacing most other markets.

A notable trend in the PE market during 2020/2021 (among many such trends) has been the number of take-private transactions by PE investors. This demonstrates the amount of dry powder available in the PE markets. It also reflects PE investors' willingness to pay higher premiums due to their ability to maximise the value of such target entities post-acquisition, with fewer administrative and governance hurdles.

1.2 What are the most significant factors currently encouraging or inhibiting private equity transactions in your jurisdiction?

The UK has historically been the largest PE market in Europe and has a long and proud history in welcoming PE sponsors to fundraise and invest there. As such, the UK has a well-established legal system and regulatory footprint to deal with various outcomes and challenges that the PE industry may face from time to time.

London, in particular, hosts many of the leading European markets and participants that are required for PE investing: sources of investor capital; debt lenders; debt markets and many others. This concentration of markets and market participants has led to most of the key U.S. and European PE investors having a presence in the city.

Whilst Brexit dominated the headlines in Europe during 2020 and parts of 2021, the PE industry appears hopeful that investors and founders alike will be given new opportunities to use the UK as a platform investing country. The COVID-19 pandemic potentially has more far-reaching consequences for the UK PE industry and this is discussed at question 1.3 below.

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

Immediately following the COVID-19 pandemic reaching its peak in March/April 2020, PE firms worked to ensure the safety of employees and customers and to shore up portfolio companies to enable them to ride out the pandemic (including taking on various sources of private and government-backed financing). The impact on PE market activity was significant, with announced PE exits dropping 70% in May 2020 *versus* May 2019.

As discussed above, from H2 2020 onwards, the PE markets rebounded strongly in the UK (and internationally). Difficulties with deal sourcing and execution, such as an inability to meet face-to-face, have largely been overcome, as is demonstrated by the rebound and the amount of capital being deployed in PE deals. The key factors that we see as enduring are:

- Valuations: PE deals are often valued on a multiple of the target business' earnings, and specifically its earnings before interest, taxes, depreciation and amortisation ("EBITDA") (amongst other methods). Buyers and sellers are having to agree adjustments to such EBITDA figures to reflect the unusual impact of the COVID-19 pandemic on the trading of target businesses. How to treat such adjustments is case-specific and a point that continues to evolve.
- Government-backed finance: Many businesses took on government or government-backed financing during the COVID-19 pandemic. The impact of this financial support continues to impact a number of sectors. PE investors are having to focus attention on this financing in target and portfolio businesses, including its impact on their ability to add/extract value from the investment.
- New sectors: The COVID-19 pandemic has changed the way that many of us live, work and consume, which has led to the expansion of some business sectors and a contraction of others. For example, the travel sector has suffered, whereas healthcare has benefitted. The ongoing impact of COVID-19 continues to affect both existing investments and current dealmaking in such sectors.

UK Government intervention into the economy to address COVID-19 has been well-publicised. Some key impacts on the PE markets have been:

- Interest rates: Base rates across the globe have been kept low, and the UK is no exception. This has encouraged capital to seek higher returns in sectors such as PE.
- Employment markets: Establishment of furlough schemes have propped up many businesses throughout the COVID-19 pandemic and kept money in the hands of consumers. PE participants will closely follow the impact of the end of such schemes.
- Loans and insolvency protection: Many businesses benefitted from direct and indirect government financial support, and certain legal protections from insolvency. Again, the end of such schemes going forwards may have an impact on which businesses are able to continue.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

There has been a continuation of the recent shift in non-traditional PE funds, such as sovereign wealth funds, pension plans and family offices moving beyond their primary focus on minority positions to increasingly serve in a "control" or lead investor-type capacity on direct investments in the PE space. The genesis of this trend has been the desire of these investors for greater control, reduced fees and greater returns on invested capital, particularly in the traditional PE space.

This shift in focus has created additional competition for traditional PE funds and is resulting in increased variation in the deployment of capital by these non-traditional PE investors across the capital structure. Many of these non-traditional PE funds are not used to a lead investor role and are therefore still refining their approach to diligence, transaction terms and governance.

Given the profile of the stakeholders in sovereign wealth funds, pension plans and family offices, there is an added emphasis on environmentally and socially responsible investments and this is expected to continue to be an area of significant focus looking ahead.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

PE transactions in the UK are typically structured using a UK private limited company limited by shares ("Topco"), commonly owned by the PE fund and management executives, which acts as the holding company for a chain of corporate entities. The bottom entity in the acquisition chain ("Bidco"), acts as the purchaser of the target shares and may act as borrower under any financing arrangements. A series of entities are typically incorporated between Topco and Bidco for tax and financing purposes, so as to allow for financing by junior lenders to be structurally subordinated to that by senior lenders.

Where transactions involve a UK target, Bidco would typically be a UK-resident limited company. However, Topco (the level at which a future sale by the PE fund of the UK acquisition usually takes place) may be a non-UK incorporated but UK-resident company as a means of mitigating UK stamp duty that is payable (usually) by a buyer at 0.5% on the future transfer or sale of shares in a UK company. It remains to be seen if increased substance requirements in typical offshore jurisdictions (such as the Cayman Islands, Bermuda and Jersey, etc.) will impact upon such UK stamp duty planning.

2.2 What are the main drivers for these acquisition structures?

Structures are typically driven by a number of factors, including: (i) the tax and other requirements of the PE funds investing in the transaction; (ii) the requirements of the lenders financing the transactions (for example, as to any required subordination); (iii) the overall tax efficiency of the post-acquisition group (for example, as to achieving the maximum deductibility of interest expense); and (iv) the requirements of management (for example, if they are seeking to qualify for business asset disposal relief (formerly entrepreneurs' relief)).

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

PE investors will typically subscribe for ordinary shares in Topco. However, the ordinary shares subscribed by the PE investor typically represent only a small proportion of its funding of the transaction. The majority of the PE investor's commitment is typically funded as shareholder debt, usually in the form of "payment in kind" ("PIK") loan notes, which carry a right to annual interest that the issuer (Topco) may choose to satisfy by the issue of further loan notes. Preference shares may be used where the shareholder debt would otherwise exceed the levels permitted by transfer pricing rules or corporate interest restriction rules. The combination of ordinary share capital, preference shares, and shareholder debt held by the PE investor is commonly referred to as the "institutional strip".

Management will commonly also take an equity piece in Topco in order to ensure their interests are aligned with the PE investors. This is often referred to as "sweet equity" or "sweat equity". In some cases, in particular on a secondary buyout where they may be required to reinvest realised gains, senior executives may invest in both the institutional strip and the sweet equity. Management equity incentive plans will often be put in place to further incentivise management and other employees.

Carried interest (a performance-related share of the fund's overall profits) is typically structured through a limited partnership, with executives as limited partners. Often, the carried interest limited partnership will itself be a special limited partner in the fund limited partnership to allow carried interest to flow through the structure on a transparent basis such that executives can benefit from capital gains tax treatment on a future exit. Entitlement to carry is typically crystallised after investors have received a return of their drawn-down capital, plus any preferred return accrued and after any other pre-agreed hurdles are achieved. As noted in section 9, recent changes to the UK tax treatment of carried interest need to be considered.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

The drivers described in question 2.2 will remain relevant but the minority position taken by a PE investor may limit the ability of the investor to dictate the relative importance of these factors.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

Management would typically hold between 5% and 15% of the equity, although this will be very transaction-specific and the proportion may be lower in larger transactions.

Transaction documents will invariably include a right for the PE investor to acquire a manager's equity following the termination of his/her employment with the relevant portfolio company. The terms of such compulsory acquisition will usually depend on whether the manager is a good leaver or a bad leaver.

"Good leavers" will commonly be entitled to receive the higher of the costs and, subject to vesting provisions, fair market value for their shares. A "bad leaver" would commonly be entitled to the lower of fair market value and cost. Vesting provisions will often determine the proportion of a good leaver's shares that will qualify for good leaver treatment. This will generally be based on the expiry of a specified vesting period (usually three to five years) following the transaction to the termination of employment. Vesting may take place on a *pro rata* "straight line" basis over the vesting period or on a "cliff edge" basis only on completion of the vesting period.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

Good leavers are typically those who cease to be employed by reason of their death or disability, retirement (although care should be taken with regard to potential discrimination under UK employment law) or, in some cases, involuntary termination without cause (for example, redundancy). There may be a discretion for management not falling within such categories to be treated as good leavers nonetheless. Typically, a leaver who is not a good leaver is a bad leaver.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

The primary contractual document controlling the governance of a PE portfolio company in the UK is generally a shareholders' agreement, setting out the arrangements agreed by the PE Sponsor, management, and any other shareholders in the company. The typical matters that this agreement will cover extend to day-to-day management appointments and behaviour, conduct of business of the company (generally expressed through the form of vetos for the PE sponsor), positive covenants for management to follow in their operation of the business, control of share transfers, information rights for the PE sponsor and controls over the raising of further equity and share capital for the company. This governance arrangement may be supported by the presence of a PE sponsor-appointed director or observer on the board of the portfolio company. The shareholders' agreement is a private contract agreed between the shareholders of the portfolio and does not generally need to be filed publicly.

Additionally, the primary constitutional document of an English company is its articles of association. Certain governance controls tend to be included in the articles by the PE sponsor (as a breach of these provisions then becomes an *ultra vires* act of the company, as opposed to merely a contractual breach), particularly in relation to transfer rights. Articles of association are a publicly filed document, so PE sponsors should be mindful of this in terms of the information included.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

Yes. These veto rights tend to be expressed via a director's veto (in circumstances where the PE Sponsor has a director appointed to the board) and/or a shareholder veto. Inevitably, there is a balance that needs to be struck (in circumstances where PE controls the majority of the investee company) between the need for the PE Sponsor to protect and manage its investment, drive an exit, and control strategic issues, and the ability of management to manage the portfolio company day-to-day.

Where PE has a minority position, the veto rights tend to be focused on protection of economic interests, and only fundamental strategic matters, i.e. anti-dilution, share transfers, exit below an agreed valuation, and fundamental change of business.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

At a shareholder level, veto rights are generally respected but can run into issues if they fall foul of certain English law rules aimed at promoting proper corporate behaviour, primarily (a) preventing actions that may unfairly prejudice a minority shareholder(s) of the company, (b) not allowing any inappropriate fettering of any statutory powers of the company, or (c) preventing actions being taken that are contrary to UK public policy.

At the level of a director nominee, the same issues can arise as outlined above. Additionally, the relevant director will, by virtue of his or her directorship, also owe a wide range of duties to the company, its shareholders (i.e. not just the appointing PE shareholder) and, if a company nears insolvency, its creditors. These duties override and can impede the exercise of certain vetos.

Vetos that are contrary to law can be challenged and may not be upheld. To ensure that a director's veto is properly implemented as between the company's shareholders, it will typically be contained in a shareholders' agreement and/or the company's articles and so (subject to the points above) can be implemented effectively among the company's shareholders.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

A PE sponsor shareholder does not *prima facie* owe duties to other shareholders in the company (save for those expressly set out in any shareholders' agreement). As explained in the answer to question 3.3 above, however, a director appointee of a PE sponsor is subject to fiduciary and statutory duties to the wider company and, in certain cases, its shareholders. Successful actions brought against PE-appointed directors on behalf of the company (a derivative action), or by an aggrieved shareholder on the basis of unfair prejudice are rarely brought, and even more rarely successful, but are available in theory.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

English law shareholders' agreements relating to an English company are generally effective and respected under English law (which is generally accepted as governing law and the jurisdiction for resolving disputes), provided that they are properly drafted. That said, provisions in shareholders' agreements that purport to offend the principles around proper corporate behaviour, outlined in the answer to question 3.3 above, can be problematic to enforce. In addition, certain legislation, for instance the European General Data Protection Regulation ("GDPR"), the UK Data Protection Act 2018 and the UK GDPR, which governs the transmission and collection of data in the European Union and the UK, can add further challenges to older shareholders' agreements that may find their existing provisions (e.g. in relation to information) ceasing to be compliant with new regulations.

Non-compete and non-solicit provisions need to be aimed at providing reasonable protection for the relevant goodwill (i.e. the investment of the PE sponsor in the company), for a reasonable period, and within a reasonable area in order to be effective under English law. As a basic position, English law dislikes covenants that attempt to unfairly restrain trade or prevent an individual from working to support him or herself, so such covenants will need to be carefully drafted in this context, in order to be effective.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

PE investors must ensure that nominee directors are eligible to act as directors, including, in particular, that they are not disqualified from acting as a director, e.g. under the UK Company Directors Disqualification Act 1986. As outlined above (particularly in the answer to question 3.3), directors of an English company (whether considered "executive" or "non-executive", and irrespective of their appointing shareholder(s)) share the same broad general fiduciary and statutory duties to the company of which they are a director. This can create personal risk and liability for the director concerned, if the director acts only in the best interests of his or her appointer. Although a PE sponsor will not incur direct liability for the actions of its appointed director, it could have indirect issues caused, including: (a) a failure of the appointed director to act as they expect or would prefer (for example, where the relevant director is subject to statutory duties requiring certain behaviour, such as placing a company into insolvency proceedings where it is insolvent); and (b) consequential issues *vis-à-vis* their investors due to their failure to procure that their investee company acts as they would prefer.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

As explained in the answer to question 3.6 above, directors appointed by PE sponsors do not only owe duties to the sponsor, but to the companies of which they are directors more generally (and therefore to the entire cohort of shareholders of such company).

The Companies Act 2006 imposes a duty on a director to avoid a "situational conflict", i.e. a situation in which he or she has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company. Clearly, a "situational conflict" could occur where the appointed director also has a directorship with companies with interests adverse to those of another company to which he or she has been appointed as a director. It should, however, be noted that a "situational conflict" can be authorised by the non-conflicted directors of the relevant company(ies), and so such authorisations should be obtained where relevant.

Additionally, directors may find themselves in a position of actual conflict in relation to existing or proposed transactions or arrangements of companies they are appointed to. This is generally known as a "transactional conflict". Directors are generally required to declare their interests in such transactions or arrangements. Having made such a disclosure, the ability for a director to participate in the decision-making process with regard to such transactions will be governed by the articles of association of the relevant company. It is not uncommon, once such interests have been declared, for a director to remain capable under the articles of participating in the relevant decisions. A director will not be in breach of duties in relation to conflicts to declare an interest in a proposed transaction if he or she acts in accordance with any provisions of the company's articles dealing with conflicts.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust, foreign direct investment and other regulatory approval requirements, disclosure obligations and financing issues?

UK transaction closing timetables are largely driven by regulatory approvals, most commonly mandatory and suspensory antitrust/foreign direct investment filings and industry-specific regulatory mandatory approvals or consents. As a rule, participants in the competitive PE market avoid including conditionality in their deal documentation, to ensure a high degree of deal certainty.

There has been a reduction in financing conditionality in recent years, particularly given the prevalence of sales by way of competitive auction processes where sellers are able to push bidders to obtain financing on a "certain funds" basis at the binding bid stage.

The prevalence of auction processes has also led to a general increase in the speed at which PE transactions are executed, with a rising number of auction processes being pre-empted by one bidder.

4.2 Have there been any discernible trends in transaction terms over recent years?

The UK PE M&A landscape continues to be generally favourable to sellers (both PE and non-PE). Recent trends include:

(i) an increase in the number of sale processes being run as competitive auctions on a tight timetable; (ii) increased prevalence of pre-emptive bids in competitive processes; (iii) further growth in the use of warranty and indemnity ("W&I") insurance, often with low residual seller liability; (iv) shorter seller liability time periods, in many cases regardless of whether W&I insurance is being used; and (v) fewer conditions to the completion of transactions, i.e. typically only those that are mandatory and/or suspensory for the transaction in the key jurisdictions of the target's operations.

However, as with all trends, there are notable exceptions and PE buyers are well placed to negotiate positions more advantageous than these industry norms, particularly by making use of speed, commerciality and other unique advantages.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

Acquisitions of the shares of public companies in the UK are generally governed by the UK City Code on Takeovers and Mergers (the "Takeover Code"). The Takeover Code imposes various rules on the conduct of such activity, generally aimed at ensuring equality of information and treatment for all of the shareholders of the target public company, including its minority shareholders. This framework is substantially more restrictive than the framework applicable to private transactions.

Provisions of the Takeover Code that are likely to be particularly relevant to PE sponsors undertaking public to private deals are: (i) specific timetables applicable to such deals; (ii) a need to announce whether or not an offer will be made for a public company within a 28-day period if the likelihood of an offer being made becomes publicly known; (iii) restrictions on the payment of break fees by public company targets on deals; and (iv) the Takeover Panel's (the entity that governs the application of the Takeover Code) increasing focus on a bidder's intentions regarding the target's business following acquisition, and the need for any plans for closures and lay-offs to be disclosed when a bidder announces its firm intention to make an offer. One year after completion of an acquisition, a bidder must confirm to the Takeover Panel whether or not it has taken the intended course of action, and publish that confirmation. Inevitable reputational consequences can follow from a failure to owner specific communicated post-offer intentions.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

Only somewhat limited protections are available. Normal measures used on private deals, such as break fees, are generally prohibited under the Takeover Code, because of concerns that such protection mechanisms deter potential bidders from submitting competing bids and therefore maximise value for shareholders in publicly listed companies. That said, the Takeover Panel may allow break fees in very limited circumstances. This can include where the target is in financial distress and seeking a bidder, or in certain hostile situations. Such break fees are then typically limited to a 1% cap of the target's value.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

"Locked-box" consideration structures remain the preferred option for PE sellers in the UK market, largely due to the ease of negotiation and the certainty they provide with respect to the final consideration paid. Combined with the shorter leakage periods being obtained by PE sellers (some as low as three months post-closing) they present a highly attractive proposal when compared to a traditional completion accounts consideration structure. An additional benefit of a "locked-box" deal is that because there is no post-closing adjustment, funds can be distributed immediately following closing, allowing a PE seller to optimise investor/LP returns.

Given that the current UK market is a seller's market, "locked-box" consideration structures are commonly accepted by buyers except in limited circumstances, including where the target is a carve-out of a larger business and separate accounts are not maintained, where there have been historical issues with accounts or audits or where some other aspect of the target or the seller profile makes the deal unsuitable for a "locked-box" consideration structure. A "locked-box" consideration structure when compared to a completion accounts consideration structure will generally be seen as shifting risk from the seller to the buyer, as the buyer (together with their advisors) will need to fully diligence the relevant "locked-box accounts" and ensure they are comfortable doing the deal on the basis of those accounts.

Where a completion accounts consideration structure is used, it is common to see a portion of the purchase price placed into escrow with a third-party escrow agent at closing as security for any post-closing payment that is required to be made by the seller as a result of the completion accounts adjustment.

Where an acquisition is made by a PE buyer in a "primary" deal (i.e. not from a PE seller), it is not unusual for a portion of the consideration to paid on a deferred basis, most commonly pursuant to an "earn-out" where the performance or growth of the acquired business will be measured against an objective criteria (usually a financial-based criteria during a defined time period) in order to determine what portion of the deferred consideration will be payable.

6.2 What is the typical package of warranties / indemnities offered by (i) a private equity seller, and (ii) the management team to a buyer?

A PE seller will in most cases only provide "fundamental" warranties, being those regarding title to shares, capacity and authority. A PE seller will only provide business and operational warranties as to the target in limited circumstances and this is becoming rarer under the current market conditions.

Business and operational warranties are usually given by certain members of the senior management team of the target and will be given subject to relatively low liability caps (dependent on the deal proceeds received by management warrantors). These business and operational warranties will be contained in a separate management warranty deed and a fulsome disclosure process will be carried out to disclose against these warranties. These management warranties are more and more being seen as a tool to elicit accurate and fulsome disclosures regarding the target from the individuals who run the business of the target on a day-to-day basis. Given the low liability caps that generally apply to these warranties from management, a buyer will typically seek to obtain coverage for these warranties above the liability cap of the management warrantors by putting in place W&I insurance.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

PE sellers will customarily provide certain pre-completion covenants and undertakings to a buyer, including: (i) a no-leakage covenant (in the case of a "locked-box" deal) where the buyer will be able to recover any leakage on a £-for-£ basis; (ii) covenants to provide assistance with, and if relevant, obtain regulatory clearances or satisfaction of other conditions; (iii) operational covenants as to how the business of the target may or may not be run in the pre-completion period; and (iv) certain limited covenants regarding the provision of information during the pre-completion period. Indemnification for specific risks is relatively uncommon for PE sellers to give, although it is sometimes seen where the PE seller and the buyer have a materially different view on the likelihood of a specific risk crystallising. More commonly, PE sellers are pushing buyers to "price in" these types of risks.

PE sellers are unlikely to give non-compete covenants, whereas it is common for exiting members of management or founders to give a full suite of restrictive covenants lasting throughout pre- and post-completion.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

W&I insurance as a product is continuing to increase in popularity with buyers and sellers seeing the benefit of the product in "bridging the divide" between sellers (including management warrantors where relevant) and buyers in terms of residual post-closing liability. It is relatively standard in a competitive sell-side process for the seller to insist on use of W&I insurance by the buyer to cover the business and operational warranties that are provided by management. In some transactions, more aggressive sellers will also insist that the buyer obtains coverage for the fundamental warranties as to title to shares, capacity and authority up to the W&I insurance policy liability cap with the seller standing behind the balance of liability above the W&I insurance policy liability cap for the fundamental warranties.

Excesses and policy limitations and resulting pricing will differ based upon, and be impacted by, insurer, industry sector, jurisdictions of operation, quality of diligence, thoroughness of disclosure process and seller/management warrantor liability cap. With respect to business and operational warranties, the usual buyer recourse profile will be first against the seller/management warrantor up to the relevant excess (which will usually match the attachment point under the W&I insurance policy) and then against the W&I policy up to the relevant liability cap of the policy. The *de minimis* financial limitation that applies to claims under the business and operational warranties will commonly match in the transaction documentation and the W&I policy and is often driven by the W&I insurer. It is unusual for sellers/management warrantors to stand behind any additional liability above the relevant W&I policy liability cap, except where the fundamental warranties are being insured. In terms of the W&I policy liability caps being obtained in buy-side W&I policies, these range from between 5% and 100% of the enterprise value, with the most common range being between 15% and 40% of the enterprise value of the target.

More recently, there has been a trend towards lower seller/management warrantor excesses (i.e. liability caps in the transaction documentation) and an excess as low as £1 can be obtained where the business of the target is considered particularly "clean" and insurable. Where management warrantors are required to have material "skin in the game" under the management warranty deed, it is common for the relevant PE seller to offset this potential liability by way of escrow or retention to fund claims against management or by way of transaction bonuses payable on closing.

The major downside of W&I insurance is that there are certain exclusions, both general to all W&I insurance policies (i.e. secondary tax liabilities, anti-bribery and corruption) and transaction-specific to address gaps in the scope of diligence carried out or particular risks relevant to the industry in which the target operates. In the current market, sellers/management warrantors do not customarily stand behind warranty claims that fall within the ambit of such policy exclusions and instead this potential risk is borne by buyers and ultimately priced in.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

Given that a PE seller's warranties will generally be limited to certain fundamental warranties as to title, capacity and authority, a PE seller's liability for these warranties is typically capped at the purchase price. Such fundamental warranties are not usually subject to additional financial limitations, such as a *de minimis* or threshold (i.e. excess). The fundamental warranties are typically given subject to time limitations of between three and seven years from closing.

Seller liability under the "no-leakage" covenant is usually uncapped and recoverable from the seller on the basis of leakage received or benefitted from, given that compliance with such a covenant is entirely within the control of the seller.

The liability of management warrantors for the business and operational warranties can be subject to various negotiated limitations, including: (i) warranties are usually given on a several basis only (i.e. each manager is only liable for its proportionate share of liability for any claim and/or its own breach); (ii) warranties can be given subject to actual awareness of the relevant management warrantor group; (iii) financial limitations as to (A) aggregate liability cap, (B) threshold, below which a warranty claim cannot be made (which can be on a "tipping" basis or "excess only" basis), and (C) *de minimis*, being the minimum quantum of liability that a warranty claim must meet in order to count towards the threshold; and (iv) time limitations within which claims under the warranties must be made, which range from between one year and three years for claims under the non-tax warranties and between four and seven years for claims under the tax warranties.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

Given PE sellers generally only provide fundamental warranties as to title, capacity and authority, no security (financial or otherwise) is provided as the risk of a breach of these warranties should be very low. With respect to the no-leakage covenant provided in "locked-box" deals, it is uncommon for PE sellers to provide any security in relation to this risk as most buyers take the view that the reputational damage caused to a PE seller for a large leakage claim is a material deterrent to the PE sponsor engaging in activity that constitutes leakage. This position also aligns with the PE industry focus of returning proceeds to LPs/investors as soon as possible post-closing in order to maximise economic return metrics.

This position is clearly at odds with the general desire of buyers (both PE and non-PE) to obtain meaningful post-closing recourse with respect to warranties and covenants. Given the fact the current market is largely a seller's market, this had been a major driving factor in the rise of W&I insurance.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buyer (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

The market has evolved such that buyers will typically provide: (i) an equity commitment letter ("ECL") in respect of the equity portion of their consideration; and (ii) "certain funds" committed debt papers ("Debt Commitment Papers") from a lender in respect of the debt portion of their consideration. In some circumstances, a buyer may provide an ECL in respect of the entire consideration and address the debt portion privately behind the scenes, although we see this less frequently in mid- and upper-market transactions.

The ECL will come from the buyer's PE fund itself, will be addressed to the buyer's Bidco, and may sometimes also be addressed to the seller. Such ECL will generally include covenants that the fund will (i) call required capital from its investors to fund the equity portion of the purchase price, and (ii) fund Bidco with the equity capital required to fund such relevant portion of the purchase price (or a seller's damages claim for failure to complete), which is subject only to the satisfaction of the conditions in the share purchase agreement. This ECL will customarily also include certain commitments from the PE sponsor aimed at ensuring Bidco draws down the requisite funds under the Debt Commitment Papers in order to complete the transaction.

The seller will usually be able to enforce the ECL commitment directly, or on behalf of Bidco, against the PE fund to the extent the transaction becomes unconditional and the buyer fails to comply with its obligations to pay the consideration under the transaction documentation. If the banks under the Debt Commitment Papers do not fund when they are legally required to, the PE buyer may be required to take certain steps to enforce against the banks and/or use reasonable endeavours to obtain alternative debt financing.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees are uncommon in the current UK PE market largely as a result of the fact that in the UK market it is not typical for a buyer to have a walk-away right between signing and closing, e.g. in the event of a "material adverse change" in the business or if the debt financing is not obtained (as opposed to the U.S., where both of these rights for buyers are more common and hence so is the use of reverse break fees).

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

Exiting from an investment by way of an IPO raises a number of issues, including (but not limited to):

- Costs: Pursuing an IPO can be considerably more costly than an exit by way of a private sale, due to the fees of the advisers involved, together with the fees of underwriting the exit. It is also likely to take longer to execute a successful IPO, perhaps up to six months, due to the various processes involved in presenting a company properly to the public markets.
- Uncertainty: Exiting from an investment via an IPO can expose PE sellers to significantly greater market risk than the relative certainty of a private deal. It is not guaranteed that sufficient investor capital will be available to support an exit. In addition, any failures of an IPO are inevitably more "public" than the failure of a private disposal process. This can add wider reputational risk to a disposal.
- Incomplete exit: When an IPO is successful, that still does not generally enable an immediate full exit for the PE fund on day one of the IPO. It is typical that the PE sponsor would be subject to a "lock-in" period for at least six months following a successful IPO, during which time it will not be able to sell its shares in the listed company. Following the end of the "lock-in" period, it is likely that an "orderly market" period (perhaps of up to 12 months) will follow, during which the sale of the PE sponsor's stake in the business can only be sold in a staggered way, to avoid affecting the price of the target company's shares too significantly as a result of the disposal.
- Unclean exit: The reluctance of a PE sponsor to provide any ongoing W&I protections in relation to the sale of their target companies is well-understood. However, in relation to any IPO of a PE-invested business, the PE sponsor will find it increasingly challenging to resist providing an investment bank underwriting the IPO with at least some warranties in relation to its ownership of the shares in the company being floated, in relation to itself and, in certain circumstances, in relation to an underlying business.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

As mentioned in the answer to question 7.1 above, the duration of the "lock-in" provided by the PE sponsor will vary from transaction to transaction but, typically, a period of at least six months following an IPO will apply. This means that no actual "exit" (in terms of realising value from the investment) will have been effected by the PE sponsor at the completion of the IPO; but only once the lock-up period has expired. In the meantime, the PE sponsor remains exposed to market risk for the duration of the "lock-in" period and, to a lesser extent, during the orderly market disposal period.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

The first quarter of 2021 saw record breaking exit values generated in the UK. Both market volatility and liquidity (across debt, public and PE markets) remain high and have sustained strong valuations. It is not uncommon to run a dual-track exit process, though a greater number of deals are concluded by way of bilateral or auction-driven private sales processes, as opposed to successful IPOs. This is reflective both of market conditions and also a general preference by funds to conclude private deals where possible, in order to avoid some of the negative aspects of IPO exits (as outlined in the answer to question 7.1 above), provided that the valuations achieved on such deals are at an acceptable level.

In order to preserve competitive tensions in deals, it is not uncommon on dual-tracks to run such processes in parallel, at least until the likely commencement of an investor "road show" in relation to the IPO process. Immediately prior to the commencement of the road show, is usually a reasonable inflexion point for the PE sponsor to consider whether it has an acceptable (and deliverable) private offer for the asset to be disposed; one reason for this being the level of information about the target that will be shared with potential investors in the road show process, and a desire to avoid this if a private sale seems feasible. Noting that, given the private nature of many of these processes, full public information about dual-track processes and their outcomes is not available, it is safe to say that it is comparatively rare for the IPO track to be abandoned during the period after the roadshows have finished, but prior to the expected date of listing and admission of the target.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Traditional bank-led leveraged loan financing remains the most common source of debt finance used to fund both mid-market and large PE transactions in the UK.

However, in recent years, there has been increasing competition between traditional bank lenders and non-bank (or "alternative") lenders for mid-market PE transactions, with funding increasingly being sought from alternative sources such as direct lending funds and other institutional investors. Participants in mid-market transactions have also increasingly looked to implement "unitranche" financing structures, pursuant to which traditional senior and junior debt tranches are replaced by a single tranche term facility carrying a single, blended rate of interest, usually on a floating rate. Other debt instruments, such as PIK or convertible debt, remains a small portion of the overall financing provided by third-party lenders.

For larger PE transactions, leveraged loans are often structured as a term loan B ("TLB") – a non-amortising, senior secured term loan usually under NY law. Investors in TLB include a mix of traditional bank lenders and institutional investors and they are designed to tap greater availability in the U.S. debt syndication markets, relative to the European Markets.

Aside from leveraged loan financing, high-yield bond financing remains an important source of funds and is commonly (albeit subject to fluctuating availability in the market) used alongside traditional senior secured bank loans.

A key theme in the UK leveraged finance market in recent years – and a function of the increased appetite of institutional investors (who traditionally invested in high-yield bonds) for leveraged loans – has been the convergence of the terms of English law leveraged loans with both high-yield bonds and U.S. leveraged loans. This has led to a general loosening of covenants in English law leveraged loans, with the market becoming more accepting of "covenant-loose" structures (that is, where the relevant loan agreement contains only a single ongoing or maintenance financial covenant, usually a leverage ratio) and, for stronger borrowers, "covenant-lite" structures (that is, where the loan agreement contains no maintenance financial covenants or only a springing leverage covenant for the benefit of the revolving creditors).

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

The UK is, generally speaking, an investor-friendly jurisdiction and there are no particular legal requirements or restrictions that would affect the choice or structure of debt financing of PE transactions in the UK. That said, practical deal concerns play an obviously important role in dictating the ultimate financing structure. For example, some PE funds have valued the lighter disclosure requirements of a leveraged bank loan as compared to a high-yield bond issuance (which requires the preparation of, amongst other things, a detailed offering memorandum). Further, in an acquisition context, another advantage of a loan (compared to a high-yield bond issuance) is that loans can typically be documented and executed on a much shorter timetable that is more aligned with the timing constraints of the acquisition itself. With its successful execution dependent on ever-fluctuating market conditions and increased disclosure requirements, a high-yield bond issuance, on the other hand, must typically either be bridged by a loan or funded into an escrow arrangement if being used to finance an acquisition.

Aside from such practical concerns, market participants should be aware of, and ensure compliance with, any industry-specific laws and regulations, as well as the broader regulatory regime affecting PE transactions.

For example, in the current sensitive political and regulatory climate, market participants need to be especially careful with regard to compliance with anti-bribery, corruption and sanctions laws. Aside from local laws, borrowers and sponsors should also be aware of the expansive nature and potential extra-territorial reach of such laws and regulations in the U.S., which can necessitate compliance by many non-U.S. entities (or entities that have only limited U.S. ties).

In the context of buyout transactions of public (as opposed to private) companies in the UK involving debt finance, a key issue will be to ensure compliance with the "certain funds" and cash confirmation requirements of the UK Takeover Code. These principles require that a bidder have the funds and resources in place on a certain funds basis to finance a proposed acquisition, prior to the public announcement of any bid (and the bidder's financial advisor must confirm the availability of such funds). In practical terms, this means that the bidder and its lenders will need to finalise and have executed the required loan documentation (and satisfy, subject to limited exceptions, the conditions precedent to the loan) at the bid stage.

The "certain funds" concept has also increasingly permeated and become a feature of private buyout transactions. Although not a legal requirement in this context, in practical terms, this means that in certain private buyout transactions, lenders will be required to confirm upfront the satisfaction of all of their financing conditions and agree to disapply loan drawstop events (other than certain limited exceptions) until after completion of the acquisition.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

The recent trends were, until the COVID-19 pandemic, mainly in favour of the borrower/sponsor side. We are seeing ever more flexibility in the additional debt baskets and in the permitted payments baskets too. There are one or two areas where the lenders have pushed back, however. For example, there is now usually a cap on the amounts that can be added to EBITDA by way of future synergies on an acquisition or group initiative. As a general comment, it is fair to say that the unitranche lenders are a little more conservative than bank lenders, perhaps reflecting the fact that they are more likely to hold the debt rather than to syndicate it away. The COVID-19 pandemic massively interrupted deal-flow in H1 2020, but as of now (October 2021), deal-flow is back where it was immediately prior to COVID-19. Terms that tightened during 2020 are also back to where they were pre-COVID-19.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

At a high level, the primary tax focus is to establish a tax-efficient structure and, in particular, to mitigate tax leakage on payment flows from the underlying portfolio companies through the acquisition structure to investors.

From an investor perspective, withholding tax is often a material factor. However, since the UK applies no withholding to dividends or capital gains, withholding tax concerns in UK transactions tend to focus on interest and the ability to reduce the 20% rate of interest withholding through treaty relief or otherwise (which can be relevant to both external and investor-related debt).

Achieving the maximum deductibility of interest expense on financing remains an important area. In addition to long-standing restrictions on the deductibility of interest (such as under the thin capitalisation rules), relatively recently introduced interest barrier rules (which generally restrict interest deductions to 30% of EBITDA) and increasingly complex anti-hybrid rules provide further limitations, particularly where U.S. investors are concerned.

From a management perspective, the key objective is to minimise income tax on acquisition of shares and to achieve capital gains tax treatment on an exit (see questions 9.2 and 9.3 below).

UK transactions tend to utilise UK-incorporated and -resident companies in the acquisition structure, although non-UK incorporated but UK tax-resident companies are sometimes preferred for stamp duty efficiency.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

Although favourable tax treatment for carried interest has become more difficult to achieve, capital gains tax remains available on carried interest returns in certain circumstances (at a 28% special rate for carried interest, compared with the normal 20%). Management will look to ensure that carried interest is not treated as income for tax purposes under the "disguised investment management fee" ("DIMF") or income-based carried interest rules.

For equity investment/co-investment, senior management may be able to claim business asset disposal relief (formerly entrepreneurs' relief) (delivering a 10% rate of capital gains tax on sale) provided certain conditions are satisfied. In particular, to be eligible, an executive must hold at least 5% of the ordinary share capital and corresponding economic and voting rights for at least two years. With effect from 11 March 2020, a lifetime allowance of £1 million of gains is eligible for business asset disposal relief (a significant reduction from the £10 million of lifetime gains eligible for relief prior to such date).

Growth shares and deferred/vesting arrangements remain relevant in the UK and are commonly used as a means of delivering capital gains tax treatment on a future sale with a minimal income tax charge on acquisition.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

Management will generally be keen to ensure that tax is deferred until any disposal proceeds are received and will want to maximise the availability of business asset disposal relief (although this will be less of a priority following the significant reduction in the lifetime allowance noted in question 9.2). Reorganisation reliefs are often available to escape a taxable disposal occurring on a rollover. Loan notes are frequently used for these purposes. A tax clearance will generally be required from HM Revenue & Customs ("HMRC") in connection with any tax-neutral rollover and should be factored into the transaction timing.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

As is the case in most other jurisdictions, the UK tax rules have changed significantly in recent years in response to the OECD's Base Erosion and Profit Shifting ("BEPS") project. Measures impacting the PE industry include:

(a) The anti-hybrid rules that potentially disallow deductions for interest and other expenses in structures involving hybrid entities or instruments. The rules are commonly a cause of uncertainty in transactions involving U.S. investors where check-the-box elections have been made through the acquisition structure. This measure, together with (b) below, has led to the increasing use of preference shares rather than debt as a source of investor finance.

(b) The interest barrier rules (see question 9.1 above).

(c) The changes to the availability of double tax treaty relief as a consequence of the adoption of the OECD's multi-lateral instrument ("MLI") that overlays the application of the UK's tax treaties with other participating jurisdictions. This has led to the increasing need for "substance" in entities seeking treaty benefits.

On an international level, the adoption of the second Anti-Tax Avoidance Directive ("ATAD II") has extended the scope of the hybrid mismatch tax rules to arrangements involving non-EU countries and so-called "reverse hybrid" mismatches. This further complicates the anti-hybrid issues discussed above. Following Brexit, the UK has largely stepped away from the mandatory disclosure rules introduced by the sixth amendment to the EU Directive on Administrative Cooperation ("DAC6") and proposes to introduce new rules in 2021, in accordance with the OECD's Mandatory Disclosure Rules.

On a domestic level, changes to the qualifying conditions for business asset disposal relief and a reduction in the available lifetime allowance from £10 million to £1 million have had a significant impact on many management teams.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

As outlined in the previous answers to the questions in this chapter, a range of UK and European laws affect PE investors and transactions. Among the most important of these is the Companies Act 2006 (which provides the basic framework of company law in England), the Financial Services and Markets Act 2000 (providing the basic framework of law relating to financial services in the UK), the Bribery Act 2010 (legislation aimed at prohibiting bribery and corruption by UK businesses and individuals worldwide), GDPR (which governs the transmission and collection of data in Europe) and the Takeover Code (referred to above). The National Security and Investment Act ("NSI") will enter into force later this year (2021) and extend the government's powers to scrutinise and intervene in investments to protect national security. Although the UK chose not to adopt the EU Sustainable Finance Disclosure Regulation or the Taxonomy Regulation following Brexit, environmental, social, and corporate governance ("ESG") matters remain high on the legislative agenda and the UK's evolving ESG regulations will affect both the operation of and reporting by PE investments.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

PE funds (like other funds) that are managed from or marketed within EU Member States will generally be subject to some, or all, of the rules of the Alternative Investment Fund Managers Directive ("AIFMD") (an EU directive that looks to place hedge funds, PE and any other alternative investment firms into a regulated framework, in order to monitor and regulate their activity). All investors, including PE funds, could be subject to UK national security screening under the NSI, which will enter into force later this year (2021) and will cover investments made by UK or non-UK investors in targets having a presence in the UK through a subsidiary sales or activities in the UK. Investments in key sectors will be subject to mandatory notification; for investments in other sectors, a voluntary filing may be advisable.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope, etc.)?

Especially given that when buying assets from other PE sponsors they may not benefit from substantive warranty protection as to the condition of the business being sold to them, PE sponsors typically require detailed legal due diligence processes to be undertaken on the assets they are considering buying. These investigations will review most legal and business aspects of the target, including (but not limited to) investigations into title, assets, material contracts, ESG, intellectual property, litigation, real estate, and compliance. These investigations tend to be conducted on an issues-focused "red-flag" basis, and to be governed by materiality thresholds aligned to the size of the deal in question.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

Anti-bribery legislation has further increased the focus of PE sponsors on the day-to-day business activities of the targets they are acquiring, and their sensitivities to various business practices and corporate conduct. This trend (driven, for instance, by the Bribery Act 2010 in the UK), has impacted the thoroughness of due diligence investigations, the day-to-day governance rights insisted upon by PE sponsors and, in some cases, the abandonment of proposed transactions due to insurmountable bribery or corruption issues in the relevant targets. In addition, the W&I insurance policies that are very often placed in connection with PE transactions generally exclude bribery and corruption from their cover.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

In general, under English law, a shareholder is not liable for the underlying activities/liabilities of the company to which the shares relate. There are only very specific instances where a PE sponsor may be held liable for its portfolio company. One such example (with reference to the answer to question 10.4 above), is that a PE sponsor could incur liability under the Bribery Act 2010 by failing to implement adequate procedures for its portfolio company, and potentially under the UK Proceeds of Crime Act 2002 (the relevant "proceeds" of the crime of the bribery concerned being the investment proceeds enjoyed by the PE sponsor from the investee company).

11 Other Useful Facts

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

The UK remains a premier place in the world for investment by PE sponsors. A degree of uncertainty accompanied the UK's departure from the European Union on 31 January 2020. However, PE investments and exit have continued apace in 2021 and the UK's legal divergence from the European Union has proven gradual. 2021 has seen several government initiatives intended to promote investment and job creation in the UK, such as the proposed creation of up to 10 freeports in locations around the UK. Aside from Brexit, many other factors remain that can influence investments by PE sponsors in the UK and there is not room to cover them all here. Topics of particular prominence in the UK at the time of writing (October 2021) are the ongoing impacts of the COVID-19 pandemic (addressed elsewhere in this chapter) and also the new NSI, which will subject investment in industries thought to be of strategic significance (e.g. defence, life sciences and healthcare) to mandatory screening. This legislation is a response to concerns around the maintenance of national independence in certain areas, influenced by greater geopolitical uncertainties. These concerns are leading to a proliferation of national security regimes around the world.

Acknowledgments

John Markland, a finance partner at Dechert LLP, Daniel Hawthorne, a tax partner at Dechert LLP, and Thomas Clarke, a corporate and securities senior associate at Dechert LLP, all contributed to this chapter.

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