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The International Comparative Legal Guide to:

Private Equity 2018

4th Edition

A practical cross-border insight into private equity

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Country Question and Answer Chapters:

EDITORIAL

Welcome to the fourth edition of *The International Comparative Legal Guide to: Private Equity*.

This guide provides the international practitioner and in-house counsel with a comprehensive worldwide legal analysis of the laws and regulations of private equity.

It is divided into two main sections:

Four general chapters. These chapters are designed to provide readers with an overview of key private equity issues, particularly from the perspective of a multi-jurisdictional transaction.

Country question and answer chapters. These provide a broad overview of common issues in private equity laws and regulations in 34 jurisdictions.

All chapters are written by leading private equity lawyers and industry specialists and we are extremely grateful for their excellent contributions.

Special thanks are reserved for the contributing editors Richard Youle and Lorenzo Corte of Skadden, Arps, Slate, Meagher & Flom LLP for their invaluable assistance.

Global Legal Group hopes that you find this guide practical and interesting.

The *International Comparative Legal Guide* series is also available online at www.iclg.com.

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Chapter 5

Australia


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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? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

Private equity represents a smaller proportion of the Australian mergers and acquisitions market compared to other markets worldwide. According to the Australian Private Equity & Venture Capital Association Limited (AVCAL), across the financial year 2017 (FY17), Private Equity (PE) fundraising in Australia was stable at A$2.03 billion and PE investments remained steady at A$3.38 billion.

The number of companies invested in by PE in FY17 fell to 39, but the value per investment rose from A$58 million in FY16 to A$75 million in FY17. The number of investments exited slowed in FY17, reflecting longer holding periods and fewer portfolio companies in the exit pipeline.

Buy-out deals – including MBOs, LBOs and take-private deals – accounted for 59% of the value of all PE investments in FY17; slightly more than the previous year and reflective of the ongoing strength in this market segment.

Take-private transactions also featured prominently during the course of the past year, such as Primavera Capital and Shanghai Pharmaceutical Holdings combining to acquire Vitaco Holdings for A$314 million in the second half of 2016, underscoring the growing appetite from Asia for Australian health food companies.

Several of the most prominent deals during the year were struck by domestic PE firms, for instance:

- Pacific Equity Partners' acquisition of Australia's largest flour manufacturer Allied Mills, added to its range of complementary baked food businesses; and
- Quadrant's purchase of Goodlife Health Clubs in October 2016, followed by Jetts Australia and Fitness First Australia towards the end of 2016, which has created a broader Fitness and Lifestyle Group to service the fast-growing wellness industry.

The proportion of expansion/growth capital deals increased (by number of deals) to 54% of all invested companies in FY17, continuing the trend seen over many years for sustained high activity in this part of the market. Overall deal value increased to A$975 million, representing a 90% increase from last year. Some of the deals completed included:

- Advent Partners' investment alongside the existing founders in Frosty Boy, a Queensland-based dessert and treat manufacturer; and
- Crescent Capital's acquisition of Tigerlily – a high-profile leading Australian swimwear business – from Billabong for A$60 million during the year.

2018 is poised to be another strong year for investment across PE and venture capital, with a collective A$7.69 billion of 'dry powder' ready to be deployed into promising high-growth business.

In terms of investment sectors in FY17, PE investments were (by value of investments) directed mostly at either of the consumer products, services and retail sector (44%) or the business/industrial products and services sector (39%).

Looking at the split by number of companies, slightly more than half (51%) of all invested companies were in the consumer products, services and retail sector. Some of the largest deals completed in FY2017 were found in this sector, underscoring the strong demand from PE firms for high quality businesses operating in this part of the market. For example:

- The Cheesecake Shop, Australia's largest specialist cake retailer through a franchise network of over 200 stores across Australia, New Zealand and the UK, was acquired by PAG Asia Capital in February 2017.
- Allegro acquired the master franchisee agreement for Pizza Hut in Australia, from US-based parent company Yum! Brands in September 2016.

The next two largest destinations for investments by number of companies were ICT (13%), the business/industrial products and services sector (10%), and healthcare and life sciences (8%).

Activity has recently been supported by interest rates remaining very low, together with the attraction for inbound investment of a lower Australian dollar foreign exchange rate than in previous years.

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

Significant factors encouraging Australian private equity transactions include:

- domestic bank interest rates staying at historic lows; and
- attractions of Australia for inbound investment through:
  - a lower Australian dollar forex rate compared to previous years;
  - a free trade agreement with the US with a threshold for US private investment in Australia which would usually not require statutory review;

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- perceptions of Australia as a "safe haven" destination compared to volatility overseas; and
- the impact of government initiatives like the Biomedical Translation Fund and the National Innovation and Science Agenda (NISA).

Significant factors inhibiting Australian private equity transactions include:

- a thinner market for deals and domestic capital; and
- a less favourable taxation regime for private equity as compared to markets such as the US and UK.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction? Have new structures increasingly developed (e.g. minority investments)?

Private equity funds can take a combination of equity and debt interests in targets, structured by any combination of:

- convertible subordinated loans. Unsecured loans subordinated to senior and mezzanine debt (e.g. acquisition debt) potentially convertible into equity immediately prior to exit;
- preference equity. Preference shares offering a coupon during the term of investment but potentially *pari passu* with ordinary shares upon exit; and/or
- ordinary shares. Potentially *pari passu* with management interests.

Warrants can also be taken by private equity funds, i.e. options over unissued shares, potentially for greater control on realisation of downside risks, e.g. unsatisfactory management performance/covenant breaches in special/distressed situations.

2.2 What are the main drivers for these acquisition structures?

Relative composition of debt/equity interests depends on factors including:

- requirements of third-party financiers, e.g. for subordination of private equity fund debt interests;
- requirements of private equity fund investors, e.g. as to balance of interim income (favouring debt/preference shares) and final capital returns (favouring equity);
- tax planning for: (a) private equity investors; (b) portfolio company, e.g. deductibility of debt interest payments; and (c) management, e.g. meeting criteria for equity tax incentives;
- prospective cash-flows, i.e. the company's ability to service existing and additional debt interest; and
- deal with incumbent/incoming management, e.g. real equity incentives.

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

Institutional investors might typically participate by acquiring bid vehicle ordinary voting shares. Management might typically be offered ordinary, but non-voting, bid vehicle shares, subject to amplification of returns by "ratchet" (see the response to question 2.5) with transfer restrictions/drag-along rights for institutional investors on exit.

2.4 What are the main drivers for these equity structures?

Typical drivers would include the overriding need of private equity investors for an orderly exit in controlling disposal of management equity, balanced against management seeking tax incentive criteria for their equity being met.

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

Vesting and compulsory acquisition provisions depend on the management interest's legal structure. Where management take actual shares, vesting and compulsory acquisition provisions will be familiar from other jurisdictions, including:

- vesting provisions whereby management's equity interest is adjusted by "ratchet" referable to factors such as length of service/the company's financial performance relative to milestones/targets; and
- compulsory acquisition provisions upon management departure, alternating between:
  - bad-leaver – management interest acquired at *cost/book value* upon departure:
    - at own volition, e.g. prior to fixed date; or
    - on termination for cause/not meeting agreed performance.
  - good-leaver – management interest acquired at *fair market value* upon departure:
    - at own volition, e.g. prior to fixed date; or
    - on faultless incapacity e.g. long-term illness/termination without cause.

Alternatives to actual shares include:

- options over unissued shares at nominal/no strike price, vesting in actual shares on service/performance-based events (potentially according to "ratchet"); exit events; and/or "good-leaver" departures; or
- phantom schemes – management receive a cash bonus of the amount their equity interest would have realised, subject to "ratchet", upon exit event or "*good-leaver*"/"*bad-leaver*" departure, being easier to operate as a simple debt obligation of the company, but possibly unpopular with management seeking a voting interest or equity tax incentive criteria being met.

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

Management voting shares, whether from the outset or subject to options that vest, would obviously tend to dilute the private equity investor's voting interest. Dilution can be mitigated by the investor's voting rights per share being increased, or by management's voting rights per share being impaired, in the company's constitution, (potentially on a matter-by-matter basis) or by provisions in the shareholders' agreement, subject to limitations described in response to question 3.3.

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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?

Private equity investors and management will often enter into a shareholders' agreement governing their relationship and commonly dealing with:

- management constitutional issues:
  - quora for directors' and shareholders' meetings;
  - director removal/nomination rights for private equity investors; and
  - potential referral rights for votes from board to shareholders where not otherwise required by statute.
- management operational issues:
  - performance targets/milestones and impact on management incentive e.g. equity "ratchet";
  - information rights over financial reports/performance against lending covenants; and
  - veto rights where not otherwise available under corporations law for:
    - dilutive issues of equity (alternatively pre-emption rights);
    - incurring (further) debts (depending upon existing negative pledges);
    - approving budgets/business plans;
    - approving M&A; and
    - approving dividends/distributions; and
- exits:
  - equity lock-ups prohibiting transfers by management/ other investors outside:
    - permitted transfers (e.g. intra-group/declarations of trust);
    - transfers subject to good-leaver/bad-leaver mechanics; and
    - pre-emption rights/drag-along/tag-along exit rights.

Shareholders' agreements for proprietary (e.g. private) companies are private contracts and, unlike in the UK, their constitutions are not ordinarily a public document, so there is not normally confidentiality lost in duplicating shareholders' agreement provisions in the constitution, where appropriate.

3.2 Do private equity investors and/or their director nominees typically enjoy significant veto rights over major corporate actions (such as acquisitions and disposals, litigation, indebtedness, changing the nature of the business, business plans and strategy, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

Yes. It is not unusual to include in shareholders' agreements veto rights against any of the following: material M&A; commencing/ defending litigation; incurring (additional) debt; changing the nature of the business; and/or adopting business plans/strategy.

Private equity investors holding minority interests (but with over 25% of voting rights) ordinarily have veto rights under the *Corporations Act* 2001 (Cth) (*Corporations Act*) over:

- modification/repeal of constitution;
- change to company name;
- change to legal classification e.g. proprietary company becoming public;
- selective reduction of capital or buy-back of shares;
- giving financial assistance; and
- members' scheme of arrangement.

Statutory veto rights can be:

- negated by increased voting rights attached to majority shares in respect of any/some/all relevant votes; or
- increased by additional shareholders' agreement veto rights (see the response to question 3.3).

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?

(i) Where the company is party, shareholders' agreement veto rights might not be effective in fettering *the company*'s statutory powers if employed *against the company* rather than its shareholders, if the English House of Lords decision in *Russell v Northern Bank Development Corporation Ltd* is applied in Australia – the same applies if such veto rights appear in the constitution.

Russell v Northern Bank may be mitigated in any event by weighted voting rights (potentially varying by subject-matter) facilitating statutory majorities not being obtainable where minorities object, even without statutory veto rights.

(ii) Nominated directors are subject to the same statutory and common law fiduciary duties as other directors. At least while the company is solvent, they have to take into account its best interests, being the interests of all shareholders, not just those who nominate them.

The exercise of a board veto willed by a shareholder might not be in the interests of all shareholders and therefore in breach of that nominated director's fiduciary duties. This could be dealt with by a provision in the shareholders' agreement/ constitution permitting directors to refer veto matters to a shareholder meeting, where fiduciary duties do not apply. Nevertheless, such a right should be considered carefully, not to become routine and may entail potential shadow director liability for nominating 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?

Legal duties are not owed as a general matter by private equity investors to minority shareholders merely by virtue of all being shareholders (fiduciary duties do not apply). The same applies *vice versa* save to the extent of fiduciary duties owed by management shareholders in their separate capacity as directors/officers. Investors may nonetheless be mindful of:

- contractual duties under shareholders' agreements, e.g. provision of financial information; and
- general legal protections for minority shareholders e.g. orders in respect of (majority) conduct deemed:
  - contrary to the interests of shareholders as a whole; or
  - oppressive to, unfairly prejudicial to, or unfairly discriminatory against, a shareholder or shareholders whether in that capacity or in any other capacity.

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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)?

(i) There is no general prohibition on shareholder agreements including non-domestic governing law and jurisdiction provisions.

(ii) Non-compete/non-solicitation provisions are subject to the same limitations as in ordinary commercial contracts, being potential invalidity under common law restraint of trade. To be enforceable, relevant provisions have to protect a legitimate business interest (e.g. private equity investor against departing management) with reasonable scope in terms of duration; and geographical/business reach.

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 under corporate law and also more generally under other applicable laws (see section 10 below)?

Overseas investors should note proprietary companies need at least one director who is ordinarily residing in Australia.

Key potential risks/liabilities for:

(i) nominee directors include:

- breach of statutory duties and common law fiduciary duties, with a wide variety of civil/criminal penalties and/or an obligation to compensate the company; and
- insolvent trading for board members when the company incurs a debt, there are reasonable grounds for suspecting that the company is or would become insolvent; and the company is insolvent, or becomes insolvent by incurring that debt.

Statutory provisions also void mitigation of these risks by companies:

- exempting liabilities incurred by persons as officers;
- indemnifying persons for most liabilities incurred as officers; and
- payment of premiums for contracts insuring officers against many liabilities for wilful breach of duty or breach of some statutory duties.

Although investors would generally be protected by corporate limited liability and the "corporate veil", key potential risks/liabilities for:

(ii) investors that nominate directors to boards include:

- "shadow director" responsibility for the liabilities described in (i) above, if the investor is deemed (amongst other things) to be a person "in accordance with whose instructions or wishes the directors of the corporation are accustomed to act". There are also exceptions to the "corporate veil", e.g. fraud.

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?

Nominated directors are *prima facie* required by statute (and potentially also by the constitution/shareholders' agreement) to notify other directors of material personal interests in matters relating to the affairs of companies due either to their: (i) relationship with their appointor; or (ii) position as directors of other portfolio companies, subject to exceptions. Notice does not, of itself, discharge the statutory duty to exercise powers in good faith in the best interests of the corporation and common law fiduciary duties.

However, statutory disclosure for proprietary companies permits (subject to constitution): (a) voting on matters relating to the interest; (b) approving transactions that relate to the interest; and (c) retaining transaction benefits. The company may not (subject to constitution) avoid transactions merely because of a disclosed director's interest or an interest within the statutory exception to disclosure.

Statutory/common law duties might also be mitigated by constitutional/shareholders' agreement provisions accepting conflicts of interests represented by appointor shareholders/appointments to other portfolio company boards, provided directors' actions are otherwise consistent with company law. Non-statutory/constitutional internal management protocols can also regulate conflicts.

4 Transaction Terms: General

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

Regulatory timing constraints include:

- Foreign investment approval. A description of all circumstances in which notification might be made under the *Foreign Acquisitions and Takeovers Act* 1975 (Cth) (as amended) and the *Foreign Acquisitions and Takeovers Regulation* 2015 (Cth), is beyond the scope of this response, but they include investors from jurisdictions without free trade agreements with Australia acquiring businesses worth over A$261 million.

  Where notification is made, the Federal Treasurer, acting on the advice of the Australian Foreign Investment Review Board, has 30 calendar days to make a decision. This period is only subject to extension at the request of the investor or upon statutory request for further information.
- Competition approval. A description of all circumstances in which approval might be sought from the Australian Competition and Consumer Commission (ACCC) under the *Competition and Consumer Act* 2010 (Cth) (CCA) is similarly beyond the scope of this response.

  Pre-transaction notification is often advisable but not mandatory. At present most notifications request informal merger approval, with no formal timetable. If notified transactions are cleared, the ACCC provides a non-binding "letter of comfort" stating no present intention to oppose.

  The informal ACCC process has two stages. Initial review/"pre-assessment" considers whether transactions *prima facie* raise competition concerns and are cleared where risk of competition issues is considered low. A significant proportion of notifications are pre-assessed quickly, often within two weeks of notification.

A second in-depth public review follows for more contentious mergers, comprising:

- two to five weeks of market inquiries with active scrutiny of information from competitors, suppliers and customers, and other interested persons;
- usually within six to 12 weeks, a decision not to oppose, or a statement of issues; and

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- if there is a statement of issues, another round of market inquiries which can take an additional six to 12 weeks, or potentially longer.

The regime is being reformed (described in response to question 10.2).

Australian Securities Exchange (ASX) listed companies are subject to continuous disclosure obligations and have a *prima facie* obligation *immediately* to disclose information (such as investment or acquisition by private equity investors) that a reasonable person would expect to have a material effect on the price or value of their securities. Disclosure can be deferred for information concerning "*an incomplete proposal or negotiation*" where it's confidential; the ASX has not formed the view that it has ceased to be confidential and a reasonable person would not expect the information to be disclosed. Where a public-to-private bidder has made a firm decision to proceed, this is communicated to the target and announced to ASX immediately with offer terms. The public-to-private bidder must make the offer within two months. It typically takes three to four months to conclude the offer and implement compulsory acquisition.

Commercial timing constraints can impact timetables, including the acquisition (and possibly syndication) of debt financing and commercial consents either to novation of, or change of control under key commercial contracts.

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

Given the more limited volume of Australian private equity transactions referred to in response to question 1.1, it is difficult to verify generalised trends in commercial terms.

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?

Public-to-private transactions comprise:

- Off-market takeover. Most takeovers are off-market, being an offer to all security holders in a bid class (whether or not listed) for all those securities or a proportion of them, implemented either by contractual takeover offer/bid or court-approved scheme of arrangement:
  - takeover bid/offer: a bidder's compulsory acquisition is ultimately permitted if the bidder and associates, by the end of the offer period, have:
    - relevant interests in at least 90% (by number) of bid class securities (whether or not acquired under the bid); and
    - acquired at least 75% (by number) of securities that the bidder offered to acquire under the bid;
  - the requirement for (broadly speaking) committed financing coupled with the uncertainty of meeting these thresholds and ultimately obtaining approval of financial assistance given by the target company in security for acquisition leverage, tends to mitigate against contractual takeover offers/bids by private equity funds; or
  - schemes of arrangement: acquisitions with consent of target security holders according to a court-approved procedure under Part 5.1 of the *Corporations Act*. The scheme must be approved by:
    - 75% by value; and (generally)
    - a bare majority in number of holders, of offer class securities present and voting in the scheme meeting. Unlike in the UK, the court has discretion to dispense with a majority headcount;
  - votes of the offeror and associates are usually excluded, which makes it difficult to execute schemes where private equity offerors already have target stakes. Schemes provide "all-or-nothing" certainty that, if approved, the offeror acquires all scheme class securities, but if not, acquires nothing at all, so external leverage need not be drawn; or (rarely).
- Market takeover bid: comprising acquisition of listed securities by contractual offer through the stock exchange, which must be for all bid class securities, unconditional and in cash. They are less flexible and less common than off-market takeovers, particularly for private equity offerors, but can prove significantly faster where possible.

Australia is less stringent than the UK in expectations of bid financing when offers are made, not requiring the equivalent of UK "cash confirmations". Nevertheless, both the Australian Takeovers Panel (Takeovers Panel) and the Australian Securities and Investments Commission (ASIC) advocate that bidders have reasonable expectations at announcement that funding (even if subject to drawdown conditions or not formally documented) will be available once an offer becomes unconditional, otherwise the Takeovers Panel can declare "unacceptable circumstances".

However, the Federal Court recently departed from an objective test for bidders to avoid being "reckless" in breach of the *Corporations Act* and suggested bidders' boards are only "reckless" if:

- subjectively aware of a substantial risk that they will not meet funding obligations if a substantial proportion of offers are accepted; and
- having regard to known circumstances, they were not justified in taking it.

Legislative reform is likely to be required to harmonise the legal position with expectations of ASIC, the Takeovers Panel and market participants.

5.2 Are break-up fees available in your jurisdiction in relation to public acquisitions? If not, what other arrangements are available, e.g. to cover aborted deal costs? If so, are such arrangements frequently agreed and what is the general range of such break-up fees?

Targets often pay break fees in recommended bids on transaction failure in circumstances such as withdrawal of target board recommendation, potentially subject to "fiduciary-outs" for superior competitive proposals.

The Takeovers Panel can declare unacceptable circumstances if the size or structure of break fees pose a disproportionate disincentive to competitive bids or unduly coerce target security holders. It considers break fees of 1% or less of target equity value "generally not unacceptable" unless payment is subject to excessive/coercive triggers. "Naked no vote" break fees (i.e. payable where a bid is rejected by security holders even in the absence of competing proposals) can fall into this category.

It is possible, but less common, for targets to seek reverse break fees upon transaction failure in circumstances such as a bidder not obtaining regulatory consent for which it was responsible, or breaching pre-bid agreements. The Takeovers Panel's 1% "rule of thumb" does not apply to reverse break fees, giving more flexibility in pricing.

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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?

Private equity sellers in secondary buy-outs might ideally prefer "locked box" structures where a fixed price is agreed over the target's historic or special purpose financial statements. The seller then covenants against value leakage from statement date to completion. This mechanism's acceptability has declined in a less buoyant market for secondary buy-outs.

Private equity buyers might prefer (and come under pressure from external financiers to require) traditional acquisition consideration structures such as "cash-free/debt-free" enterprise valuation subject to adjustment by completion accounts for a target's completion: (i) cash; (ii) net debt; and/or (iii) working capital (against expectation).

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

Private equity sellers typically try to minimise warranties/ indemnities on secondary buy-outs to pursue "clean exits" distributing sale proceeds quickly to investors. Sellers often claim to be "passive investors" not sufficiently informed in the day-to-day operation of the target to give business warranties, trying to restrict coverage to title to shares, capacity and authority. Buyers in secondary buy-outs typically seek to resist such an approach, unless factored into the consideration paid, and the final outcome will ultimately depend upon a range of factors and the competitive forces at work.

The seller's management team's position depends on whether they remain with the company. It will not necessarily make sense for the buyer to seek aggressive legal recourse against incumbent management of their new portfolio company, which mitigates the value of their warranties/indemnities. Management will often claim an inability in any event to resource substantial liability, trying to limit exposure to a low multiple of annual salary.

Buyers seeking substantive recourse from such sellers and management might initially be told to "bridge the gap" with warranty and indemnity insurance (see the response to question 6.4).

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?

Private equity sellers typically agree covenants/undertakings from signing to completion for maintenance of present conduct of target business (whether or not to support "locked box" consideration) and assistance with regulatory filings. Covenants could be extended to management, depending upon whether they remain with target (i.e. some buyers might not consider them necessary for management transferring to them). Sellers might also have to stand behind taxation/environmental indemnities.

Non-compete/non-solicitation covenants might also be sought from both sellers and management, particularly seller non-solicitation where management remain with the target.

6.4 Is warranty and indemnity insurance used to "bridge the gap" where only limited warranties are given by the private equity seller and is it common for this to be offered by private equity sellers as part of the sales process? If so, what are the typical (i) excesses/ policy limits, and (ii) carve-outs/exclusions from such warranty and indemnity insurance policies?

Warranty and indemnity insurance is certainly available both buyer-side (against the buyer's losses upon acquisition) and seller-side (against the seller's liabilities to the buyer under contractual warranties and indemnities, which can leave the buyer taking credit risk on both the seller and insurer). It is not unusual for sellers, who wish to limit their exposure or avoid retentions in escrow, to suggest it.

As (generally) a bespoke non-standardised product, it is difficult to generalise as to typical policy terms, but: (i) excesses/policy limits (and therefore an element of co-insurance from seller) are typical but quantum responds to transaction size/premium pricing; and (ii) carve-outs/exclusions typically include:

- seller's fraud (excluded from buyer-side policies);
- matters known to the buyer at completion;
- consequential losses (e.g. lost profits); and
- environmental liabilities, unless specifically negotiated for inclusion.

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

To the extent sellers are successful in limiting warranties/ indemnities to title/capacity/authority (see the response to question 6.2), secondary buy-out acquirers should expect them to be uncapped or subject to cap equal to aggregate purchase price. The management team might try to cap their liability at the deductible/ excess of applicable insurance or at a relatively low multiple of aggregate salaries.

Other limitations will be familiar from general corporate transactions, e.g.:

- *de minimis* thresholds on an individual and/or aggregate "basket" basis below which claims are inadmissible and above which claims are permitted either on a whole liability or excess-only basis;
- time limitations normally being:
  - one audit cycle for general business warranties (e.g. 12–18 months from completion); and
  - longer for long-tail liabilities, e.g. tax/environmental claims.

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)?

(i) Sellers typically resist customary requests on secondary buy-outs for purchase price retention in escrow pending term expiry of (most) warranties/indemnities, as escrow impedes distribution of sale proceeds from the seller fund to investors. Ultimately, presence/absence of escrow should therefore factor in valuation discussions.

(ii) Buyers in secondary buy-outs ideally seek escrow support for warranties/liabilities from both seller and management. Departing management can find it more difficult to argue

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against because they are not generally under the same pressure for rapid distribution of proceeds. In either case, secondary buy-out acquirers face suggestions insurance is an appropriate substitute for escrow (see the response to question 6.4).

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 if commitments to, or obtained by, an SPV are not complied with (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

(i) The debt financing package is often set out in a debt commitment letter and term sheet, replaceable with definitive financing documents if the private equity bid is successful.

(ii) Buyers' equity funding commitments are also often set out in commitment letters addressed to target, which represent that the buyer has sufficient equity to meet purchase document obligations and commit to drawing down equity finance subject to transaction conditions precedent. It is not unheard of in Australia for sellers to obtain specifically enforceable rights against buyers for an "equity cure" should debt financing not transpire, potentially subject to clean-up grace periods for buyers otherwise in default.

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 certainly possible (but not necessarily prevalent) in public-to-private transactions (see the response to question 5.2), but less prevalent in private transactions.

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?

Once a private equity investor wishes to conduct an IPO in respect of a portfolio company, the existing shareholders' agreement will be terminated. Neither ASX Listing Rules nor market practice generally permit typical provisions in shareholder agreements including weighted voting rights and drag-along rights.

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

Historically, Australian sellers were not restrained from disposing their shareholding on IPO, but recently the Australian market has caught up with the US – exiting sellers are often required to retain a substantial target stake at least until release of the first full-year financial results post-listing. Apollo Global Management LLC and Oaktree Capital Management L.P. entered into voluntary escrow in respect of shares held by their funds upon IPO of Nine Entertainment Co. Holdings Limited until publication of the company's full-year results. In a common exception to "lock-up", they could sell-down 25% of their shares in escrow if first half-yearly results had been published and the share price over 20 days was at least 20% higher than the IPO price.

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?

Private equity-backed IPOs are not especially common, with AVCAL identifying 30 such IPOs on the ASX for calendar years 2013, 2014 and 2015 with an offer size of at least A$100 million, many of which were not run as an alternative to trade sales, which would not suggest a general preference for dual-tracks.

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).

Senior secured debt and mezzanine (or subordinated) debt are the most common sources of funding for private equity transactions in Australia, initial buy-out financing traditionally being limited to a few institutional bank lenders. After the global financial crisis, it became more expensive for buyers to obtain such bank funding for leveraged buy-outs and some sponsors therefore brokered their own syndicated financing. High yield bonds and securitisation structures have not generally been taken up, but bridge loans have occasionally been used to fund acquisitions, which might then be replaced by high yield debt or retail debt securities, but this has not been typical.

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?

Like the UK but unlike much of the US, Australia has a statutory prohibition upon financial assistance given by a company to a person to acquire shares in that company or in its holding company. The prohibition typically pertains to the giving of security for acquisition debt without direct consideration. "Whitewash" shareholder approval either by a unanimous shareholder resolution or by a special resolution (75%) passed by shareholders other than the buyer and its associates, is required to the extent financial assistance is materially prejudicial to the interests of the company or its shareholders or its ability to pay its creditors. If required, shareholder approval must be obtained and ASIC notified thereof at least 14 days before the giving of the financial assistance.

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?

A key tax consideration for investors is classification of their investment as debt or equity to determine corporate tax treatment of returns (i.e. potentially a deductible interest expense or potentially a frankable dividend, respectively). Determination is made by Division 974 of the *Income Tax Assessment Act* 1997 (Cth). Broadly speaking, it operates to treat all holders of: ordinary shares; preference

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shares; convertible securities; and securities, the returns of which are a function of target performance, as holders of *equity interests* provided they do not also satisfy the requirements of a *debt interest*. Usually, an arrangement will satisfy the requirements of a *debt interest* if the entity subject to it has an effectively non-contingent obligation under the arrangement to provide a benefit in the future (e.g. the repayment of a loan) and it is substantially more likely than not that the value provided will at least be equal to the value received.

Off-shore tax structures are common in the Australian private equity landscape. Traditionally, the legal vehicle most commonly used has been the limited partnership domiciled in a jurisdiction offering tax neutrality, such as Delaware, the Cayman Islands or the British Virgin Islands. However, Australia proposes to introduce a new corporate collective investment vehicle (CCIV) regime to be implemented in two phases via amendments to the existing tax legislation. The proposed CCIV regime will provide investors with the ability to obtain deemed capital gains tax treatment and a reduced rate of withholding tax when investing from a country that has entered into an exchange of information agreement with Australia.

It is worthwhile to also note that the Australian Taxation Office (ATO), in its efforts to combat multinational tax avoidance, is reviewing the structures created and held off-shore by multinational corporate groups to which Australia's cross-border and general anti-avoidance rules may apply. Where applicable, the Part IVA Anti-Avoidance Rule and the newly established Multinational Anti-Avoidance Law (MAAL), which came to effect on 1 January 2016, may result in Australian or off-shore companies being liable to pay significant Australian tax.

9.2 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?

If management hold target equity, they are commonly given bidding vehicle shares in exchange, structured typically to obtain capital gains tax (CGT) rollover relief (deferring taxes otherwise imposed on exchange). Conditions to relief include a requirement for an entity becoming the owner of 80% or more of target voting shares by virtue of the rollover transaction.

9.3 What are the key tax-efficient arrangements that are typically considered by management teams in private equity portfolio companies (such as growth shares, deferred / vesting arrangements, "entrepreneurs' relief" or "employee shareholder status" in the UK)?

Shares and options granted for less than market value may be subject to employee share scheme (ESS) provisions resulting in gain being taxed as income rather than capital. The taxing point under those provisions is either upon grant or on a deferred basis (i.e. until vesting or exercise). Tax may generally be deferred for qualifying options until exercise, rather than vesting. To qualify for deferral an employee can hold up to 10% of the ownership interests of the employer for up to 15 years from grant.

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?

Domestic funds are often structured as unit trusts that qualify for the Managed Investment Trust (MIT) regime, generally permitting flow-through tax treatment of income and profits to the investor for qualifying trusts. On 4 May 2016, a package of four bills was passed into law by Parliament which created a new elective regime for Attribution Managed Investment Trusts (AMITs). At its core is the ability of qualifying AMITs to "flow through" taxable income to their unitholders on an "attribution basis" and for that income to retain its character for tax purposes as it flows through the trust at trustees' election, giving them the flexibility to choose the ultimate tax treatment of portfolio gains.

10 Legal and Regulatory Matters

10.1 What are the key laws and regulations affecting private equity investors and transactions in your jurisdiction, including those that impact private equity transactions differently to other types of transaction?

Outside taxation, private equity investors and transactions are subject to the same corporate laws that apply to any other corporate investors and transactions. They are therefore subject to the *Corporations Act*, foreign investment rules under the *Foreign Acquisitions and Takeovers Act* 1975 (Cth) (as amended), competition rules under the *Competition and Consumer Act* 2010 (Cth) and, in respect of public-to-private transactions, the ASX Listing Rules and the guidance notes of the Takeovers Panel.

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

Substantial reforms of Australia's foreign investment review laws came into effect in 2016 which included:

- raising the "*substantial interest*" threshold in portfolio companies at the monetary threshold subject to potential notification from 15% to 20%;
- new application fees for notifications;
- enshrining in law the previous 'policy' that an interest in greater than 5% in a media company must be notified to the FIRB;
- the introduction of substantial fees for applying for foreign investment approval (A$25,300 for most business and corporate acquisitions); and
- a separate A$55 million notification threshold for investment in 'Agribusiness', defined as a company or business where more than 25% of the total earnings or 25% of total assets relate to agriculture, forestry or fishing or to the manufacture of certain food products.

Competition and Consumer Laws

The Competition & Consumer Amendment (Competition Policy Review) Bill 2017 was passed in October 2017. The changes include:

- the broadening of the scope of the joint venture exception to cartel conduct;
- the restriction on "concerted practices";
- the change to the treatment of third-line forcing (vertical trading restriction);
- the approach to resale price maintenance (i.e. the supply of goods on the condition that the goods not be sold below a price specified by the supplier); and
- the empowerment of the ACCC with a new "class exemption power" for particular kinds of conduct to create "safe

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harbours" for business, and thereby reduce compliance and administration costs associated with individual authorisations.

Media Ownership Laws

Substantial reforms of media ownership laws were made in 2017 with the passing of the *Broadcasting Legislation Amendment (Broadcasting Reform) Act* 2017 and *Commercial Broadcasting (Tax) Act* 2017. Reforms included the:

- repeal of the "reach rule", which prevented a person exercising control of commercial television broadcasting licences whose combined licence area exceeds 75% of Australia's population. The repeal technically permits some mergers between metropolitan and regional broadcasters, although it remains to be seen whether any will transpire in practice;
- repeal of the rule banning a person controlling more than two-out-of-three platforms – TV, radio or newspaper – in any one commercial radio licence area;
- abolition of the broadcasting licence fees and data-casting charges, ultimately to be substituted by a different basis for broadcasting taxation; and
- establishment of a fund for regional and small publishers, totalling A$60.4 million over three years, to be overseen by the Australian Communications and Media Authority (ACMA).

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.)? Do private equity investors engage outside counsel / professionals to conduct all legal/compliance due diligence or is any conducted in-house?

Prudent private equity investors conduct intensive legal due diligence with the benefit of outside counsel. Timeframes, materiality and scope should always be tailored to the circumstances of the transaction (practicable due diligence being more constrained in an auction sale compared to purely bilateral arrangements and in respect of public-to-private transactions compared to private sales).

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.)?

Prudent private equity investors should be concerned about target compliance with anti-bribery and anti-corruption legislation, particularly given that bribery of domestic public officials, and foreign public officials in some circumstances, is a criminal offence under the *Criminal Code Act* 1995 (Cth), which could lead to multi-million dollar fines for corporates. This has been reflected by a general extension of contractual protection for buyers against a target's non-compliance.

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?

Per the response to question 3.6, (i) private equity investors may in exceptional circumstances be liable for liabilities of underlying portfolio companies, including due to breach of applicable laws, notwithstanding general application of limited liability and the "corporate veil", e.g. "shadow director" liability where the investor is deemed to be a person "*in accordance with whose instructions or wishes the directors of the corporation are accustomed to act*".

It is difficult to conceive circumstances where, (ii) one portfolio company may be held liable for the liabilities of another outside of contractual cross-guarantees, but it might still occur under exceptions to the "corporate veil", e.g. group arrangements are deemed to be a fraud/sham.

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?

Australia is a relatively open economy with a freely floating currency and no foreign exchange controls. It has well-developed financial markets and a sophisticated professional services sector, with a strong and impartial legal and judicial system that remains very similar to that of the UK. It is thus a jurisdiction posing relatively few concerns to private equity investors.

These responses describe the law in force as at 23 March 2018.

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