EMPEA

Legal & Regulatory Bulletin

An EMPEA Publication

Our Fall Bulletin focuses on regulatory changes, which impact and will be of interest to practitioners in the emerging market private capital investment community.

Of note are changes to ways in which private equity investment is regulated in Brazil, an overview of potential shareholder and director liability in troubled investee companies in Nigeria, a regional overview of practical considerations for engaging in private equity and venture capital transactions in the Middle East and trending considerations for end-of-life funds.

We anticipate that some of these matters will continue to resonate and interest attendees at the October EMPEA and The Financial Times Private Equity Week in London including the inaugural *Sustainable Investing in Emerging Markets Summit*, 25th October and the 8th *Private Equity Africa Summit*, 26th October.

In this Bulletin our contributors focus on:

Considerations of End-of-Life Funds: This is an in-depth exploration of issues impacting fund-sponsored restructurings, liquidity events and tail-end options. Consideration is also given to the increasing use of fund manager-led secondary structurings.

Brazil's issuance of new regulations governing the formation, operation and management of private equity funds: This is a comprehensive overview of the main changes ushered in by these regulations and highlights matters that require adjustment to harmonise with existing regulations.

Nigeria's recent recession and rules governing potential shareholder and director liabilities in troubled investee companies: With the recent declaration of recession at the end of the second quarter in Nigeria by the Nigerian Bureau of Statistics, here is a timely consideration of potential investor and director exposure to liabilities of ailing investee companies.

Middle-East-based companies in popular sectors such as healthcare are proving to be attractive to investors. This article provides ten tips for private equity and venture capital transactions in the Middle East.

EMPEA Regulatory Affairs Resources:

- **EMPEA's regulatory advocacy resources** support members as they seek to encourage legal and regulatory enabling environments in emerging markets that don't disadvantage private investment. Contact: Ann Marie Plubell, VP, Regulatory Affairs plubella@empea.net.
- **EMPEA Guidelines** set out key legal and tax regimes optimal for the development of private equity and are now available in numerous languages including Arabic, Burmese, Chinese (simplified character), Portuguese and Spanish on the EMPEA website. A Vietnamese language version will soon be available.
- **EMPEA Legal & Regulatory Council** draws on deep subject matter expertise in the emerging markets practice to address trending concerns.
- **EMPEA Legal & Regulatory Bulletin** publishes key perspectives and insights of in-house legal officers and leading practitioners into the current challenges and concerns of the emerging markets community.
- **EMPEA education courses and resources for emerging market regulators, pension and policy oversight officials** highlight the foundational issues relating to the development and regulation of private equity in developing economies.

I look forward to seeing many of you in London and invite you to share your thoughts with Ann Marie Plubell, EMPEA VP, Regulatory Affairs at plubella@empea.net.

Best wishes for the autumn season to you all,

Mark Kenderdine-Davies
General Counsel and Company Secretary, CDC Group plc
Chair, EMPEA, Legal & Regulatory Council

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About EMPEA

EMPEA is *the* global industry association for private capital in emerging markets. We are an independent non-profit organization with over 300 member firms, comprising institutional investors, fund managers and industry advisors, who together manage more than US$1 trillion of assets and have offices in more than 100 countries across the globe. Our members share EMPEA's belief that private capital is a highly suited investment strategy in emerging markets, delivering attractive long-term investment returns and promoting the sustainable growth of companies and economies. We support our members through global authoritative intelligence, conferences, networking, education and advocacy. For more information, visit empea.org.

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Considerations for End-Of-Life Funds – Fund Sponsor-Led Fund Restructurings, Liquidity Events and Tail-End Options

By Matthew Griffin, White & Case

In the past, managers encountering issues realising value to investors within the terms of their funds were left with few options. The maturing of the secondary market increasingly provides managers with the opportunity to obtain capital to restructure and reorganise their funds and management arrangements by way of transactions that were unheard of a decade ago. Such restructurings, often called "GP-led restructurings," turn to a maturing fund secondary market with significant amounts of capital to deploy in secondary transactions and a willingness to enter into complex transactions to provide greater returns to investors.

GP-led restructurings involve providing a liquidity option for existing investors to allow them to exit a fund through either a sale of their interests or a realisation of the value of their interests as part of a fund restructuring. In the first instance, there is an acquisition of the interests of investors wishing to exit and in the second instance there is a provision of funding to such investors to enable a realisation of their interests. The liquidity is provided by one or more secondary investors, which may include existing investors or new third party investors.[1] The mechanics are considered further below.

Investors wishing to exit through a liquidity event may be prepared to compromise long-term value for liquidity and certainty, which presents the opportunity for secondary buyers or existing investors wishing to increase their exposure to the fund.

GP-led secondary restructurings

Although each GP-led restructuring is situation and document specific, there are certain basic types of transactions which have emerged. One element that they have in common is that they are complex and generally present difficult conflict and logistical issues. Accordingly, they should not be approached casually. Intermediaries usually play a key function. The key intermediaries have the rolodex of potential purchasers and expertise in advising on the dynamics and implementation of GP-led restructurings. Lawyers are also critical to not only document, but also to advise on the complex securities law and conflict of interest issues which arise in each such transaction.

GP-led restructurings can be implemented in a number of ways, but the two most common are:

Purchase of fund interests: A tender offer is made by a secondary buyer for some or all of the interests in the fund. It may be that the tender price is set through an initial buyer bidding process, perhaps facilitated by an intermediary, where buyers are asked how much and on what terms they would be prepared to acquire some or all of the fund interests. A buyer is then selected by the manager. That buyer makes a tender offer to acquire interests from some or all fund investors. The mechanics of the offer may vary from deal to deal. The buyers and sellers will then enter into

According to Jonathan Abecassis at leading intermediary Credit Suisse, the key general advantage to a GP-led restructuring is that selling an asset outright forces all investors out at the 'market' price at that time whether they like it or not, whereas GP-led restructurings provide the opportunity to maintain or increase exposure to the assets—the key question being whether there is a material trade-off in price for exiting investors in providing that option?

1. Secondary liquidity events also may occur where the manager wishes to facilitate the exit of certain investors during the fund term, for example where there have been changes of circumstances such that a significant percentage of investors favour an exit, or a manager wishes to actively manage its investor base with a view to the next fundraising.

purchase agreements, under which the buyer will acquire the interests at one or more closings. As the manager is intimately involved in a GP-led restructuring, the buyer may look to the manager, rather than the sellers, to provide certain comforts concerning the fund interests being sold, such that the purchase agreement between buyer and seller can be relatively short form. Regardless of how short form the purchase agreement, sellers are likely to engage their own counsel and may seek to negotiate a bilateral deal with the buyer. This can make the process lengthy and difficult. Some buyers insist upon a take it or leave it approach, with the risk that they do not acquire as many interests as they may wish. The secondary buyer may commit additional powder to a new vehicle to support existing investments, follow-ons or provide a new lease of life to the manager for making new investments. That vehicle may be open to existing investors as well. It may also be possible for the secondary buyer and existing investors to provide debt to the fund to support existing and follow-on investments on a preferred basis to the other fund interests. Whether through a new vehicle or injection of debt, the additional funding arrangements are likely to require approvals under the fund documents and raise questions about the value at which such investment is made relative to earlier investment by the existing fund. In addition to the bilateral negotiation issue, another complexity is the difficulty amending any terms of the existing fund document, for example, to reset the economics to provide incentive to the manager. In many, if not almost all, GP-led restructuring cases there is no carried interest payable, so some reset of economics may be considered preferable to properly align investor and investment team interests. However, changing the economics of a fund often requires the consent of affected investors. It may be possible that some investors agree to such changes and others do not, which could result in different classes of investor.

Transfer of Assets: A buyer or manager wishing to avoid multiple bilateral negotiations with selling investors, or wanting to implement a different deal to the existing fund terms may agree to effect a GP-led restructure through the transfer of assets to a new fund vehicle. In these cases, the manager forms a new fund vehicle, sells the fund assets into the new fund, provides existing investors with an opportunity to roll over their interest into the new fund, the secondary buyer provides capital to the new fund (or existing investors increase their capital), such additional capital is then applied to the asset purchase price and used to pay out the investors wanting liquidity. This structure has the advantage of being able to amend the terms of the fund but there are a number of complexities with this mechanic. There may be tax implications arising from the asset sale and roll-over of existing interests, there may be issues arising with respect to the portfolio companies (which could include regulatory issues if they are regulated, issues with debt covenants, issues under portfolio company shareholder agreements and governing documents) and there may be issues with not providing investors with a *status quo* option if the terms of the new fund vehicle vary too much from the existing fund vehicle. The lack of a *status quo* option also places great stress on the valuation and asset purchase price, which would need to fairly compensate those electing to exit and consequently, may not make the restructuring as attractive to a secondary purchaser as the fund interest purchase mechanic above. The sale of the assets is likely to be a cross-fund transaction under the fund documents, and there will likely need to be conflict approvals under the fund documents. Despite the above hurdles, these transactions are implemented. In the US, merger laws are sometimes used to facilitate the implementation of this form of GP-led restructuring.

Conflicts of Interest

Both deal structures described above have complex logistical and conflict issues, and will usually require investor or advisory committee consents. Earlier this year, the US SEC indicated that GP-led restructurings are on its radar, particularly from a fees and conflict of interest perspective, and specifically, whether investors choosing liquidity are getting fair value relative to the benefits to the manager and any incoming buyer. The SEC has also indicated that it is preparing fund restructuring guidelines. Conflict issues arise from the outset, including in the choice of buyer. Even if the manager runs an auction process to select the buyer, if the manager chooses a buyer based on the best deal for itself rather than the investors, it may leave itself open for challenge. For investors one of the major issues is information asymmetry. Both the manager and the buyer are likely to have more information about the fund, its investments and the restructure arrangements than the investors. There is no easy way to balance those scales. But critical in any process is transparency and the

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provision of information for investors to make informed choices. In addition, fair and equal treatment of investors is often required directly or indirectly by regulators of the manager. Thus, it is likely necessary to provide updated accounts and disclosure to investors prior to implementing any GP-led restructure.

Costs and Management Time

GP-led restructurings are complex for both sponsors and investors. In addition to the management time involved, there is also the question of who bears the costs. Market practice diverges on whether buyers or sellers or both bear the costs (we have seen all combinations) and how much, if anything, is borne by the manager. It is difficult for a fund being restructured to bear the costs where they would burden investors seeking a *status quo* option.

Investors, in particular, may not have the resources or know-how to properly consider such GP-led restructuring transactions. Investors will typically incur costs assessing their preferred option and obtaining legal and tax advice on its implications. Consequently, investor relations and management are key to successful implementation of a GP-led restructuring.

Investor Advisory Committee

Advisory committees can be a helpful mechanism for investor engagement in the process of a GP-led restructuring. However, advisory committees typically exist only by virtue of the fund documents and do not have any general decision making power in respect of funds. Consequently, advisory committee members are likely to limit any active role, including decisions, consents or approvals to matters on which the fund documents expressly provides for them. However, whether expressly provided or not, advisory committees may be able to guide or advise managers and engagement may be helpful as their consent may be required in respect of conflict matters. Notwithstanding the important role that an advisory committee can play in the monitoring of investor interests throughout a GP-led restructuring, care should also be given to sharing information with all investors, and not just advisory committee members.

Alternatives

Alternatives to the above mechanisms include re-opening the fund to new investment, or bringing in third party debt, with the proceeds being used to redeem investors seeking liquidity. However, such arrangements usually have substantial consent requirements, most likely unanimous, and in the case of re-opening the fund, present additional conflict of interest, valuation and other complexities.

If few investors are seeking liquidity, the manager may be happy to manage the assets to realisation following the end of the term of the fund, or may seek to distribute such assets in specie to investors, which may prompt investors to seek a GP-led restructuring. If the management fee ends or reduces at the end of the term of the fund, the manager may seek extensions of the term of the fund to extend the management fee period.

Conclusion

Unheard of a decade ago, GP-led restructurings are now occurring frequently. It seems certain that as the execution process becomes more efficient they will occur even more frequently. They are complex and costly transactions to implement, and conflict and information asymmetry issues are difficult to resolve. But, if properly managed these can be valuable processes providing advantages to all key parties as well as an additional mechanism to deal with the otherwise potentially limited range of options for end-of-life funds.

About the Author

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Potential Shareholder and Director Liabilities in Troubled Investee Companies

by Chike Obianwu* and Modupe Dabiri,* Templars, Nigeria

Introduction

Recent news out of the Nigerian National Bureau of Statistics (NBS) has confirmed that, as of the end of the second quarter of 2016, the country had gone into recession for the first time in over twenty years. In a news conference held in September 2016 however, the Governor of the Central Bank of Nigeria suggested that the country's economy may have already hit the bottom, and hence was likely to return to positive growth by the end of 2016.

Pending the predicted return to growth however, quite a number of Nigerian businesses have continued to bleed as a result of the inclement macroeconomic conditions and, more particularly, the drastic devaluation of the local currency over the past year and a half, as well as the severe shortage of foreign exchange in the economy.

Against this background, private equity investors and others with interests in Nigerian businesses would naturally be seeking measures aimed at storm-proofing their investments. And where the relevant businesses happen to be in financial difficulty, such investors are likely to be concerned about any potential exposure to shareholder or director liability resulting from activities of the ailing businesses.

This article considers the risk of such liabilities and provides guidance on practical steps that may be taken to address those risks.

Would an investor be exposed to any liability by virtue of its status as a Shareholder of an ailing company in Nigeria?

Based on the strict application of the concepts of the separate personality of the company and limitation of liability, shareholders of a Nigerian limited company, whether it is solvent or insolvent, are generally not liable for the debts of the company.[2] Hence except for any associated reputational issues or any contractually agreed additional funding commitments on its part, an investor in a financially stressed company is highly unlikely to incur any liabilities merely on account of their status as shareholder.

For completeness though, there are certain very limited circumstances under which the veil of incorporation of the company could be lifted by the courts so as to expose a shareholder to liability along with or in place of the company, and these. include, fraudulent trading (discussed in more detail below in relation to directors), and such inapplicable cases as companies formed for purposes of fraud, illegality or tax evasion.

Where an investor has one or more representatives on the board of the company, would they be exposed to any liability by virtue of their position or role as such director(s)?

Directors of a Nigerian company are subject to a number of duties to the company, the breach of which may (in certain specific circumstances) lead to personal liability, or disqualification from company directorship or management.

> “The directors have a duty to act in such a manner as to promote the success of the company for the benefit of its shareholders as a whole. And this duty remains in place at all times during the life of the company – from incorporation to liquidation or dissolution.

2. We have assumed that the investee business would in nearly every case be a limited company, since the other two possible types of company, the unlimited company or a company limited by guarantee are unlikely to be used in practice. And for a number of local reasons non-residents would be unable to invest directly in unincorporated business forms.

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The directors have a duty to act in such a manner as to promote the success of the company for the benefit of its shareholders as a whole. And this duty remains in place at all times during the life of the company – from incorporation to liquidation or dissolution.

Unlike the position in such jurisdictions as England, where the duties of the directors are said to shift from serving the interests of the shareholders to those of creditors, when the company enters into the zone of insolvency or financial difficulty, the directors of a Nigerian company continue to owe their duties to the company and its shareholders regardless.

That said however, the directors of ailing companies must at all times be mindful of the risks of being found liable for fraudulent or reckless trading, misfeasance or breach of duty. These considerations are relevant for present or previous, as well as substantive, alternate or shadow directors, a shadow director being a person on whose instructions substantive director(s) of a company are accustomed to act.

Fraudulent or reckless trading

Liability for fraudulent or reckless trading may only arise after a company has gone into liquidation. And it would arise where the business of the company is found to have been carried on in a reckless manner or with an intention to defraud creditors of the company or creditors of any other person for any fraudulent purpose.

In other words, liability for reckless trading may be established even if there is no fraudulent or dishonest intention, provided that there has been recklessness in the conduct of the business of the company, and that liability may attach not only to the management or to directors, but also to anyone who is knowingly party to the fraudulent or reckless trading.

Investors and their representatives on the boards of investee companies should therefore be careful not to allow the company to trade and incur debt at a time when they know or should reasonably have known that there is no reasonable prospect of that debt being paid when it falls due.

The penalties that a court may impose in relation to fraudulent or reckless trading include personal liability for all or some of the resulting debts or liabilities of the company. Separate from personal liability in the manner just mentioned, a court may may impose a penalty of 2 years' imprisonment or a fine of ₦2,500 (approx. US$8) or both, where the crime is accompanied with intent to defraud as opposed to mere recklessness. In other words, if a director or other relevant person only carried on the business of the company in a reckless manner, without any intent to defraud for fraudulent purpose, no criminal liability would attach to them, however, they may be liable for the debts of the company incurred in such reckless manner.

Misfeasance and Breach of Duty

Another possible exposure is liability for misfeasance and breach of duty which may also arise in the course of winding up of the company. Where any present or previous director is found by the court to have misapplied or retained the company's monies or property, or had been guilty of any misfeasance or breach of duty, such director may be directed by the court to restore such monies or property by way of compensation to the company.

Investors and their representatives on the board should be mindful of a potential review by the courts of any past acts of the directors, and where misfeasance or breach of duty can be established and is found to have resulted in actual loss to the company, such directors may be required to contribute to the assets of the company.

Group Companies

Where the ailing company is a member of a group of companies, care must be taken to assess the position of each of those companies separately as the interests of one company may be in conflict with those of others. Directors must therefore at all times be mindful of the fact that their duties are owed to specific standalone companies rather than the group as one body, so as to avoid the risk of incurring liabilities in relation to one company in the pursuit of the interests of an affiliate.

Disqualification of Directors

Where, following the company going into insolvency, a court finds after a public examination that any of the directors have committed fraud with, against or in the business of the company, the relevant director may be disqualified from the directorship or management of any company for a period up to 10 years.

> "Where the ailing company is a member of a group of companies, care must be taken to assess the position of each of those companies separately as the interests of one company may be in conflict with those of others.

Can one or more directors file for insolvency if they are uncomfortable?

Although directors of a Nigerian company run the risk of liability for fraudulent or reckless trading (as already highlighted), they do not have a duty to put the company into insolvency, nor do they have any direct power to do so. They can certainly recommend that the company file for insolvency, but the legal power to commence the process rests squarely with the shareholders or creditors of the company, or in very special cases, the relevant regulator. That said, it may well be that a determined director could apply to the court to commence insolvency proceedings against the company under the omnibus ground that it is just and equitable in the specific circumstances of the company that it be wound up by the court.

Practical steps to mitigate liability

In order to minimise the risks highlighted in this article, directors and (where applicable) shareholders of Nigerian companies in financial difficulty would do well to take the following common sense steps:

- Obtain formal legal and financial advice in relation to all major steps that they take.
- Actively and regularly review the financial position and solvency of the company, and in this connection, ensure that proper accounting procedures are in place.
- Hold regular, full and proper board meetings which should be properly minuted and, to the extent possible, attended by the company's or the board's legal and financial advisers.
- Regularly consider the realistic prospects of the business and such options as a sale, restructuring, or alternative financing.
- Minimise incurrence of new debt except where such debt is essential to keep the company afloat and is in the best interests of the company.
- Be mindful of the risk that any supervisors or managers on whose instructions the director is accustomed to act in the discharge of his directors' duties may be held to be shadow directors of the company and hence potentially liable to some of the liabilities already discussed.
- To the extent that he has not participated in any act that may be fraudulent or criminal in nature either before or during the winding up of the company, resignation may protect a director from liability. Whether or not this is an appropriate course of action would depend on such factors as its potential impact on the reputation of the director or the investor that they represent on the board, and the resulting inability of the relevant director to continue to play a role in shaping the direction of the company.

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New Brazilian Regulations Promote Important Changes for Private Equity Funds ("FIPs") in Brazil

By Antonio Felix de Araujo Cintra, partner at TozziniFreire Advogados

On August 30 this year the Brazilian Securities Commission ("Comissão de Valores Mobiliários" or "CVM") enacted Instruction CVM No. 578 ("Instruction 578") to govern the formation, operation and management of private equity funds in Brazil. Instruction 578 revoked and replaced Instruction CVM No. 391, as amended, as well as several other regulations on the matter and is now the main regulation concerning private equity funds formed in Brazil.

Instruction 578 was enacted after a long consultation process conducted by the CVM, during which it published an initial draft and asked for comments and suggestions from the market. The draft received several comments from important Brazilian organizations such as ABVCAP and ANBIMA, as well as comments from market players, law firms and individuals.

With the final wording of Instruction 578, the CVM showed that it took a real interest in the comments it received from the public and enacted new rules that we hope will facilitate the activities of fund administrators, portfolio managers and investors in Brazil. The purpose of this article is solely to summarize some of the main innovations in the rules and not to enter into all the details of Instruction 578, which would require a much lengthier work.

> "With the final wording of Instruction 578, the CVM showed that it took a real interest in the comments it received from the public and enacted new rules that we hope will facilitate the activities of fund administrators, portfolio managers and investors in Brazil.

1. Registration.

One of the difficulties under the previous regulations was that the rule provided for the "automatic" registration of the FIP but the CVM did not have in place a system able to confirm immediately the registration. This problem generally caused most fund managers to wait until they received a registration letter from the CVM. Such process brought some uncertainty to the registration process.
Under the new system the registration will also be granted automatically once the relevant documents are filed with the CVM, but until the CVM implements a system for automatic registration the registration will be effective 10 business days after the filing (unless the CVM replies earlier with requests for amendments or clarifications on the documents).

2. Eligible assets.

The main change in the rules regarding the types of assets that a FIP may invest in is the authorization for FIPs (i) to invest in non-convertible debentures and (ii) to invest in quotas of limited-liability companies (usually referred to in Brazil as "Limitadas" or "Ltdas").

The investment in non-convertible debentures is limited to 30% of the subscribed capital of the FIP (except for both Infrastructure FIPs and Research, Development and Innovation FIPs, which are not subject to the 30% limitation). This new rule will certainly provide flexibility for the managers of the FIPs and the controlling shareholders of the invested companies, which are now allowed to negotiate and structure the investments more freely investment structures that contemplate a debt and equity mix.

The other important type of asset that FIPs may now purchase is quotas of Ltdas. This is a good innovation of the new regulations, because Ltdas, due to their simplicity and lower operational cost, are the preferred type of company chosen by startups. The purpose of the CVM was precisely to enable FIPs to invest in new businesses and for that reason only Ltdas with gross revenues lower than or equal to R$16 million may receive such investments. Once a Ltda reaches the R$16 million threshold it will have to be converted into a corporation (“SA”) and adopt all governance rules required from any company invested by FIPs.

It is important to note that the existing requirement that a FIP must participate in the decision taking processes of the invested companies is applicable to the two new classes of assets described in the preceding paragraphs. Therefore, the terms and conditions of the debentures will have to contain specific provisions granting rights to the debenture holders to have an influence in the management and strategies of the issuer. The same requirement applies in the case of Ltdas, which articles of association will have to assure certain rights to the FIP to enable it to exert some influence in the management of the company.

In addition, another innovation is that Instruction 478 allows a FIP, provided it meets some requirements, to transfer funds to the invested company as advances for future capital increases (a transaction usually know in Brazil by its acronym “AFAC”). This is a very common alternative for Brazilian shareholders to provide emergency funds to a company, which are interest free and must be later incorporated into the company’s corporate capital.

3. Influence in management

Another innovation brought by Instruction 478 is the determination of certain instances where a FIP is not required to have influence in the management and strategies of the invested company. This may happen when either (i) the investment of the FIP in the relevant company is reduced to less than half of the original investment and represents less than 15% of the capital of the invested company or (ii) the accounting value of the investment has been reduced to zero and the majority of the investors agree in a general meeting to give up such rights.

Moreover, a FIP is not required to have influence in the company if it invests in companies listed in a special access segment of a stock exchange the rules of which require the listed companies to adopt governance rules stricter than those required by law. As general rule, this type of investment is limited to 35% of the subscribed capital of the FIP.

4. Investments abroad

As a general rule, a FIP is allowed to invest up to 20% of its subscribed capital in assets located abroad (provided that the assets have the same economic nature of the assets in which the FIP is allowed to invest in Brazil). On the other hand, Multi-Strategy FIPs which accept only investments of professional investors (as defined under the relevant regulations), may invest up to 100% of their subscribed capital in non-Brazilian assets. As a reference, professional investors are currently defined as investors that have at least R$ 10 million invested in financial assets.

5. Types of funds

One of the main innovations of Instruction 578 is that it has consolidated a number of different rules and divided FIPs in five different categories: (i) Seed Capital; (ii) Emerging Companies; (iii) Infrastructure, (iv) Resarch, Development and Innovation and (v) Multi-Strategy.

The following items contain a very brief summary of the main features each type of FIP:

(i) FIP–Seed Capital (“FIP – Capital Semente”): which sole purpose is to invest in companies having annual gross revenues of less than R$ 16 million. It may invest in Ltdas., which are not required to be adopt special governance rules;

(ii) FIP – Emerging Companies (“FIP – Empresas Emergentes”): for investments in companies having annual gross revenues of less than R$ 300 million, which may be subject to less strict governance rules than the ones generally applied for companies invested by FIPs;

(iii) FIP–Infrastructure and FIP – Research Development and Innovation (FIP – Infraestrutura and FIP – Produção Econômica Intensiva em Pesquisa, Desenvolvimento e Inovação): for investments of companies which develop infrastructure projects or are involved in the economic production in research, development and innovation in energy, transportation, water and sanitation, irrigation, and other priority areas defined by the Federal Government. Such FIPs may invest 100% of their subscribed capital in non-convertible debentures issued by the invested companies;

(iv) FIP–Multi-Strategy (FIP Multiestrategia): are FIPs that do not fit into any of the previous types. They have no restrictions as to their investments and may even make the same investments made by the special purpose FIPs mentioned above.

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6. Classes of quotas

The by-laws (Regulamento) of a FIP may attribute to one or more classes of quotas different economic-financial rights in connection with both the determination of the administration and management fees and the order of preference in the payment of income, amortizations or the liquidation balance of the fund. FIPs that are open exclusively to professional investors may attribute other economic-financial rights in addition of the ones mentioned in the preceding sentence.

Moreover, the by-laws of a FIP may have one or more classes of quotas that give special political rights in connection with the matters specified therein.

7. Administrator and manager

The main innovation with respect to the management of FIPs is the clarification of the different roles played by the administrator and the manager of the fund.

The main obligations of the Administrator continue to be the ones more related to the operational aspects of the fund, such as keeping the shares register, organizing the general meetings of investors, hiring a custodian for the assets of the fund and generally making sure that the fund is always in compliance with its bylaws.

The Manager's role, on the other hand, is mainly related the management of the investments of the FIP. In this capacity, the Manager has, among other duties, to prepare and disclose the investors any researches and studies made in connection with the investments and divestments of the FIP, to sign shareholders' agreements on behalf of the FIP, and to exercise effective influence in the management and strategies in the investment companies.

The issues discussed above do not cover all changes implemented by CVM in the regulations governing FIPs, which, as mentioned before, represent a major review of the rules. There are several other details that will have to be adjusted for the FIPs to become compliant with the new rules. One should note that FIPs existing before the enactment of Instruction 578 will have 12 months, as of the publication of the new rules, to adapt their by-laws to Instruction 578, unless they start a new public offering of quotas, in which case the adjustments will have to be made at the time of the offering.

Simultaneously with Instruction 578, the CVM enacted also Instruction CVM No. 579, which provides for criteria that FIPs must use in its accounting statements. Although also very important, the analysis of Instruction 579 falls out of the scope of this article.

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10 Tips for Private Equity and Venture Capital Transactions in the Middle East

By Nabil Issa and Osama Audi, King & Spalding

In this article King & Spaulding set out some of the common issues faced by parties, particularly PE and VC investors, purchasing Middle East-based companies in the popular healthcare, education and food and beverage sectors with a focus on companies in the Kingdom of Saudi Arabia and the United Arab Emirates (UAE).

1. Purchasers need to understand the regulatory issues relating to their nationality and the sector in which they are investing prior to making such investment.

If a purchaser has any non-GCC national ownership at any level of its equity capital structure, time will need to be spent confirming if the target sector is open to investment (and if investment is limited in the relevant sector whether such limitation applies to non-GCC nationals as well or to nationals of the country in which investment is being undertaken) and the relevant percentage which can be acquired by, as applicable, a 'non-GCC' purchaser or a national of a country other than the country in which the activity is being undertaken. For example, in Saudi Arabia a non-GCC investor can directly invest in a hospital with more than 100 beds or in an entity manufacturing medical devices, but cannot directly own a stake in a medical or dental clinic as health care clinics in Saudi Arabia can only be owned by Saudi nationals. In addition, non-GCC national investors can often invest in a business engaged in wholesale or retail sale of goods (including consumer goods) but not if such entity is a registered distributor of such goods. In Saudi Arabia, additional limitations will apply to quite a few other commercial activities including, among others, retail pharmacies, education, logistics, and security services. Even with regulatory hurdles, counsel should be able to explore alternative legal means through which a purchaser can acquire an interest in a target in such sector through alternative legal investment structures such as a fund or sukuk. The structure also may influence the ability to create a robust employee stock option plan, particularly if employees include non-GCC nationals.

2. While fronting arrangements are common, anti-fronting legislation must be complied with nonetheless.

Purchasers should shy away from typical nominee structures that may result in a party running afoul of a relevant anti-fronting law and, depending on the jurisdiction, if reported could face civil or criminal penalties. For example, the stated objective of the UAE Anti-Fronting Law is to prevent non-UAE nationals – whether natural or juristic persons – to practice any economic or professional activity that is not permissible for them to practice in accordance with the law and decrees of the UAE. Despite the existence of such laws in Saudi Arabia and the UAE, some lawyers have advocated for the use of simple side agreements. We are aware that certain lawyers in the UAE often point to the fact that there is actually evidence that the highest courts in the Emirates of Dubai and Abu Dhabi have historically upheld "side" agreements and focused on the economic rather than statutory relationship of the parties. Moreover, the argument has also been repeatedly made that if "side" agreements were invalidated such would result in adversely affecting foreign investment in the UAE and would be contrary to various declarations by the governments at the federal and emirate level that the UAE is encouraging foreign investment. We note, however, that the Union Supreme Court in Abu Dhabi in late 2012 decided that "side" agreements are not valid, and any agreement to vary the economic or other rights of the shareholders in a UAE joint venture should be in the registered articles and/or be recognized by a local notary public and undergo the normal recognition of the licensing authorities in the relevant Emirates. While such

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case does not have precedential value in creating binding precedent as in a common law jurisdiction, foreign parties need to be mindful that there are examples of the judiciary invalidating such agreements and that such "side" agreements likely violate the antifronting law. Moreover, there are often legal means of achieving economic control. For example, in the Emirate of Abu Dhabi it is possible to have the registered articles provide that the foreign 49% registered owner is entitled to at least 90% of the dividends. Further in Saudi Arabia, the local authorities are regularly prosecuting parties violating the Saudi Arabian Anti-Fronting law and actually reward parties for reporting those engaged in this activity. We also understand that auditors in Saudi Arabia are now required to report the extent they are aware of not only registered owners but of "beneficial" owners of a business in their filing with the Department of Zakat & Income Taxation. Finally, there are greater demands and a higher level of liability on directors under the new companies laws in Saudi Arabia and the UAE and such directors should carefully review the legality of the ownership of companies and operation of such companies prior to agreeing to act as directors.

3. Term Sheet.

Purchasers often wish to enter into a term sheet, memorandum of understanding or offer letter before documenting a complex share purchase agreement and, if applicable, shareholders' agreement. We find, however, that parties can sometimes gloss over key-terms at the offer letter stage and, accordingly, do not have a true "meeting of the minds" which can lead to significant resources being expended on a deal that was never truly agreed. For example, we find parties will agree to certain points in a term sheet and not consider the fact that they may not be enforceable, such as drag/tag provisions, ability to get certain reserved matters in the registered articles, liability caps, time limits for raising warranty claims, employee stock options, escrow arrangements, acquisitions being subject to financing, etc. By spending more time at the term sheet stage, parties can ensure that there is a clear understanding of the requirements of both purchasers and sellers.

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4. Nominee Owners/Third Parties.

As with many other sectors, quite a few healthcare, education and food & beverage transactions involve the participation of either nominee owners or historically passive owners. We often find that when such owners become aware that a private equity group, strategic investor or fund is keen to acquire the underlying business that such nominees or passive owners suddenly wish to become actively involved and expect to sell their shares at a significant premium. In a UAE or Saudi limited liability company, from a practical perspective, one shareholder cannot sell without obtaining the written consent of all other shareholders. If one party does not provide written consent they can effectively hold their shares ransom until they feel they are adequately compensated. Thus, a purchaser may wish to negotiate a break-fee if sellers cannot complete a sale due to an uncooperative nominee/ owner. Break-fees often at least include expenditures and some agreed amount to compensate the purchaser for lost time spent on the transaction. Also, indemnities should be carefully crafted to address issues which may arise as a result of a previous nominee owner being deemed to have been in violation of the relevant jurisdiction's anti-fronting law. Purchasers will often want to ensure they are indemnified for the legal violations as a result of the way in which the previous owner held the asset.

5. Exclusivity.

A company that is in negotiations to sell a minority or majority stake to a reputable purchaser may attempt to shop an offer letter to other potential purchasers. Despite confidentiality clauses, the Middle East is a relatively small market and other potential buyers will likely inevitably learn that a stake in a company is for sale. Therefore, it is critical that the concerned buyer negotiate a well drafted exclusivity clause with an enforceable termination or break-fee if sellers breach the exclusivity arrangements. In addition, depending on the governing law used in the offer letter, parties should consider whether a provision requiring parties to negotiate in good faith should be included in the offer letter. We have seen purchasers successfully demand payment of a break-fee when a seller changes its mind or pursue new purchasers. Depending on the governing law and jurisdiction used in the term sheet, the break-fee can be a liquidated damages clause that must be carefully crafted so as to not be interpreted as a punitive penalty clause which may not be enforced.

6. For transactions in Saudi Arabia, the Ministry of Labor's Saudization program adds complexity and, if ignored, can lead to significant issues.

Since the launch of Saudi Arabia's Nitiqat Saudization program, labor intensive businesses have faced challenges trying to comply with the program without significantly increasing their overheads. In general, the program categorizes all businesses as either 'red', 'yellow', 'green' or 'platinum' depending on the number of Saudi nationals employed by such company and the activity/job description of such employees with a certificate being issued by the Saudi Ministry of Labor setting out each company's current status. Depending on the color-coding of a target company, the Ministry of Labor will provide certain incentives or penalties (e.g. residency visa processing and renewals are quicker for 'platinum' companies while such services are not permitted for 'red' companies). Thus, a purchaser should be prepared to invest in a Saudization program to recruit and train Saudi nationals.

7. Competition approvals may be required for your transaction.

Purchasers should be aware that while competition approvals have been a long-standing feature of M&A/PE transactions in many jurisdictions, the competition approval processes in most regional jurisdictions are relatively new and untested. That being said both Saudi Arabia and the UAE have competition authorities to which certain transactions must be submitted and approved as a condition to closing.

8. Governing Law and Jurisdiction.

Not infrequently a foreign buyer will agree to arbitration in London to settle any disputes arising under the joint venture, and perhaps will even agree to use English law as the governing law for the shareholders agreement. A foreign shareholder may initially feel elated at this "win," but the reality may be different. There are only a handful of recent examples of arbitral awards rendered outside of the Gulf Cooperation Council countries ever being enforced in the UAE or Saudi Arabia. It may be preferable for the foreign partner to carefully consider whether to have the arbitration conducted in the English language under the DIFC-LCIA rules at the Dubai International Financial Centre (DIFC). While it is common to have the acquisition documentation governed by one law (e.g. English law) and, to the extent applicable, a shareholders' agreement governed by another law (e.g. UAE or Saudi law), purchasers should discuss with counsel the benefits and detriments that a particular governing law and jurisdiction can have on their transaction. Parties should also be mindful that the official language of the GCC is Arabic and that should consider adding provisions in the relevant agreement that it will solely appoint a licensed translator in the event such documents require translation.

9. Consider utilizing the DIFC to improve enforcement.

Because the articles of association of limited liability companies incorporated on-shore in the UAE and in Saudi Arabia do not permit much flexibility or customization, purchasers acquiring less than 100% of a target will typically enter into a separate shareholders' agreement setting out, amongst others, buy-sell provisions, or put and call options, or restrictive covenants of one sort or another. It is important to note, however, that courts in the UAE or Saudi Arabia rarely, if ever, grant specific performance – which is to say that they will not make anyone do anything. Instead they may choose to award money damages for something done or not done, but that raises the question of the quantum of harm done. One common provision in many shareholders' agreements which deals with "deadlock" in decision making, or serious disputes between shareholders, is to provide for a buy-sell mechanism, whereby one party names a price at which the joint venture interest could be bought or sold. The other party may either buy-out or sell to the first party at the named price. Another common provision is the concept of dilution: if one partner refuses to contribute equity capital as needed, the other partner can contribute and dilute the interests of the first, possibly removing some voting rights or board representation in the process. Neither of these provisions will work in Saudi Arabia, where any change in shareholding must be consented to by all existing shareholders, all of whom must appear in front of a notary public to sign amended articles of association that specify the new shareholding. Buyers should consider moving all or part of their acquisition structure to an offshore jurisdiction such as the Cayman Islands or, if the target must be at least GCC-owned, to the DIFC. We have found that many GCC jurisdictions, including Saudi Arabia, Kuwait and Dubai, view the DIFC as being in the GCC to the extent such entity is GCCowned. Thus, in many cases, it may make sense to establish a joint venture in the DIFC and create an English law joint venture agreement. Such will dramatically improve the ability to enforce put and call options, dilution provisions, have different classes of shares, enforceable employee stock option plants, reserved matters, pledge of shares, etc.

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10. Restructuring for eventual exit.

A buyer must carefully consider its structure for making an investment. Buyers should create a structure that will maximize exit options. For example, a party outside of Saudi Arabia that holds shares directly in an unlisted company will be subject to a 20% capital gains tax on exit. By creating another SPV between the buyer and the target company, such capital gains tax can be eliminated resulting in a much lower taxation on exit. A buyer may also wish to agree upfront with the seller and remaining shareholders how an exit will work or the need to convert the company to a joint stock company for an eventual initial public offering.

Conclusion

To protect their rights, investors should retain experienced counsel who understand both Western documentation and local law implications. The region is witnessing an increase in transactions especially in healthcare, education, food and beverage, and real estate/ hospitality transactions. Regional governments are also working to support startups and small business through funding programs and will likely focus on such sectors of employment for nationals for economic diversification and a means to empower the young and increasingly educated populations. We also note that a number of public private partnerships are emerging in the healthcare, education, power, transportation and other sectors throughout the GCC.

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