GETTING THE DEAL THROUGH

Private Equity

Fund formation and transactions in 42 jurisdictions worldwide

2009

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Law Business Research

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Romania

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1 Types of private equity transactions

What different types of private equity transactions occur in your jurisdiction?

Romanian law is very permissive in this respect. All types of private equity transaction may occur – management buyout, leveraged buyout, merger and acquisition (sale of shares or assets, or both). In the last few years, private equity transactions were bolstered by the privatisation of many companies, and are currently also encouraged by a low, flat income tax of 16 per cent. Private equity transactions are usually performed as a sale of shares.

2 Corporate governance rules

What are the implications of corporate governance rules for private equity transactions? Are there any advantages to going private in leveraged buyout or similar transactions? What are the effects of corporate governance rules on companies that, following a private equity transaction, remain or become public companies?

According to the Romanian law on commercial companies No. 31/1990, the commercial companies are governed either by a board of directors (monistic system) or by a board of directors and a supervisory council (dualistic system). As far as stock companies are concerned, both monistic and dualistic systems are applicable, depending on the constitutive act and on the stockholders will. The Romanian corporate governance rules provide the powers, the responsibilities and the relations between the executive, non-executive and independent directors. A very important provision regards the liability of all the persons engaged in running and controlling the company, meaning all types of directors and internal or external auditors. Independent from the corporate governance structure, private equity transactions are decided by the General Assembly according to the provisions of the constitutive act and of the law. According to Romanian law, the public or private regime of a company that follows a private equity transaction is decided by the constitutive act of the company, without being influenced by corporate governance rules.

The legal provisions make a significant contribution to private equity transactions, since they offer a higher guarantee of the company's past governance and the possibility of easily changing its corporate structure. The management of stock companies is flexible, adaptable to the size of the business and its practical needs. The amendment also makes a clear distinction between the body that runs the company (supervisory council) and the management of the company (board of directors).

An advantage of going private in a leveraged buyout is that information regarding the shareholders is kept private, in the shareholders' register, and the transfer of shares becomes much more flexible, subject only to the decision of the shareholders.

3 Issues facing public company boards

What are the issues facing boards of directors of public companies considering entering into a going-private or private equity transaction? What is the role of a special committee in such a transaction where management members of the board are participating in the transaction?

Private equity transactions involving public companies are separately regulated by the Capital Market Law 2004. The Romanian National Securities Commission (CNVM) must approve the offer prospectus before it is made public. This approval does not assess the merits of the purported transaction, it only states whether the offer is consistent with the conditions prescribed by the law (eg, the price). This conservative procedure is still complicated and bureaucratic, and inconsistent with the introduction of the dualistic management system, which is therefore left without an important function.

In the case of a going-private management buyout, since the board of directors of the target company must present a considered opinion on the share transfer, the respective members of the board of directors clearly have a conflict of interests, since their position as part of the management of the company presumes they are acting in the best interests of the company, and not their own. However, the law allows a person to be both a shareholder and a director and, in the case of an MBO, the only condition is that the directors concerned cannot vote in matters where they have a conflict of interest. If they fail to comply, any resolutions adopted are null and void. Outside of these matters, the directors must fulfil their duties as usual and cooperate with other members of the board.

4 Disclosure issues

Are there heightened disclosure issues in connection with going-private transactions or other private equity transactions?

As mentioned above, preliminary approval of the offer prospectus takes place outside of the target company, therefore strict disclosure requirements must be followed.

The public bid is preceded by a request for approval of the prospectus, submitted to the CNVM. Once the offer is approved, the offeror must publicise such offer by the means indicated by the law. Any publicity of the offer prior to approval by the CNVM is strictly forbidden, and the information published must be in accord with the approved prospectus. The price and the minimum contents of a bid must be set in accordance with the rules of the CNVM (harmonised with Directive 2003/71/EC) and the offer must ensure equal treatment of all investors.

5 Timing considerations

What are the timing considerations for a going-private or other private equity transaction?

As a general rule, a private equity transaction is more time-effective than a going-private transaction. As far as going-private transactions are concerned, the timeline cannot be determined outright, since the main component, the duration of the bid, must be set out by the offeror. In addition to this aspect, we must also consider some legal terms, especially from the secondary legislation issued by the CNVM. For example, regarding the offer prospectus, the CNVM must render its decision within 10 days of the registration of the public sale offer. The board of directors of the target company is required to submit its opinion on the merits of the takeover to the CNVM, the employees, the offeror and the market operator within five days. Once control of the company is acquired, the company is delisted, a procedure run ex officio by the CNVM.

Nevertheless, the acquisition may entail obtaining the approval of the Romanian Competition Council (or the European Commission), something that might prolong the duration of the process.

Private equity transactions involving private companies are usually far simpler, because publicity of the share transfer is contained in the shareholders' register, kept privately at the company's headquarters. In such a case, the parties conclude a share sale-purchase agreement, and then the vendor has to pay tax on the capital gains resulting from such transfer, until the 25th of the following month. Once the payment of this tax (16 per cent) is proved, the new owner of the shares can be registered in the shareholders' register as well as with the Trade Register. This type of transaction does not require any kind of approval, either from the CNVM or the board of directors, however, the competition issues referred to above may still arise.

6 Purchase agreements

What purchase agreement issues are specific to private equity transactions?

As a general rule, private equity transactions entered into in Romania specifically provide for financing conditions, a payment mechanism, representations and warranties of each party, as well as other provisions suitable for the relevant operation. Financing is a very important component of the deal, which sometimes complicates the whole process and becomes a separate but intimately linked operation. The payment mechanism sometimes works as a guarantee for the seller fulfilling certain conditions precedent.

The structure of the transaction is inspired by English common law, adapted to the restrictions imposed by Romanian law, especially in the field of the securities market and direct taxation.

7 Participation of target company's management

How can management of the target company participate in a going-private transaction? What are the principal executive compensation issues?

The legislative modification of the Law in June 2007 has also affected the relationship between management and the company. According to the new regulation, in the case of stock corporations, the directors cannot be employed by the company. The contractual relationship is therefore much more flexible: either a management contract, a civil commitment or some other type of contract. This way, directors can benefit from the incentives offered to employees (such as stock option plans, private pension fund contributions, private medical insurance), but also other types of remuneration based on their results. For example, they may be awarded preferred shares, ie, shares giving the right to dividends with priority over other shareholders, but no right to cast a vote in the general assembly of shareholders.

Romanian law allows directors to be shareholders also, and vice versa, therefore the management can buy out or buy in any kind of private equity transaction.

8 Tax issues

What are the basic tax issues involved in private equity transactions? Can share acquisitions be classified as asset acquisitions for tax purposes?

The taxation depends on the type of transaction. The stocks operable on the market are taxable at 16 per cent. If the previous owner has held the shares for more than 365 days, since in this case the purchaser would only have to pay tax on the capital gains at 1 per cent, instead of 16 per cent if the shares were held for less than one year. As for the possibility of the sale of assets, the tax rate is also 16 per cent, but the price is not taxed directly and would be included in the calculation of taxable profit. The assignment regime differs depending on whether the company is public or private.

The financing of small and medium-sized enterprises (SMEs) also enjoys a preferential tax regime, although this is thoroughly regulated and subject to many conditions, according to which SMEs can opt to pay a worldwide income tax of 2.5 per cent in 2008 and 3 per cent in 2009.

However, a proper tax assessment concerning private equity transactions implies comparative analysis between debt and equity financing. Let us assume that company A is a shareholder of B, a Romanian corporation. B requires capital to finance its activity; therefore A can either subscribe to additional shares of B or loan B the same amount (€1 million). B earns an income of €100,000 and distributes the entire after-tax income as dividends. The rates of withholding taxes are 16 per cent, both on dividends and on interest, while the interest rate is 10 per cent. The comparison of tax results shows the following.

Comparative analysis of debt and equity financing

	Debt (€)	Equity (€)
Corporate income	100,000	100,000
Deduction of interest	100,000	N/A
Taxable income	0	100,000
Corporate tax (16%)	0	16,000
Dividends	0	84,000
Withholding tax (16%)	16,000	13,440
Total tax	16,000	29,440

As the results show, financing a corporation with debt is more advantageous, since interest is deductible, while dividends are not. To prevent this tax avoidance scheme, the Romanian Fiscal Code has recently implemented thin capitalisation rules, stipulating that the deduction for interest paid is denied if the debt-to-equity ratio is higher than 3:1. The difference made by the Romanian Code is that these provisions apply not only to loans from related entities but to all kinds of loans, provided that the maturity date is longer than one year.

9 Existing indebtedness

What issues are raised by existing indebtedness at a potential target of a private equity transaction? How are these issues resolved?

If the target company already has significant debts, the first solution would be to insert a condition precedent in the contract that the company must pay the said debt before a given date. Certain guar-

antees are made to provide for the possible outcomes: remedy of the indebtedness, or persistence of the situation.

The second possibility would be to have the buyer take over the existing indebtedness, which will lower the price of the transaction. The problem arising here is that, according to Romanian law, the reassignment of debt is not possible, therefore a simple notification to the creditors that the debtor has changed would not suffice. The only viable possibility would be to have the obligations novated (ie, to change the former obligation into a new one, by the substitution of the debtor, consented to by the creditor), mentioning the buyer as the debtor.

Another specific outcome is when the target company becomes bankrupt and insolvency procedures are initiated. Usually, this only happens if the real indebtedness has been concealed by the former shareholders, therefore to prevent such a fraudulent conveyance, the parties insert warranties in the share sale and purchase contract.

10 Debt financing structures

What types of debt are used to finance going-private or private equity transactions? Do margin loan restrictions affect the debt financing structure of these transactions?

The forms of debt financing allowed under Romanian law are loans and the issuance of bonds. Loans can be contracted with the shareholders, private persons or banks, while bonds are subject to restrictive regulation in a joint-stock company, among which is the condition of a resolution being passed by the board of directors approving this method of financing, and the possibility of a conversion into shares.

11 Debt and equity financing provisions

What provisions relating to debt and equity financing are typically found in a going-private transaction? What other documents set out the expected financing?

For these types of transaction the provisions as prescribed by the Company Law (31/1990), the Capital Market Law (297/2004) and by the Securities Law (99/1999) will be applicable.

12 Fraudulent conveyance issues

Do private equity transactions involving leverage raise 'fraudulent conveyance' issues? How are these issues typically handled in a going-private transaction?

Under Romanian law, issues of fraudulent conveyance typically arise in insolvency matters. The law settles this problem by conferring on the liquidator the possibility of repealing fraudulent acts concluded prior to the initiation of the insolvency procedure.

13 Shareholders' agreements

What are the key provisions in shareholders' agreements covering minority investments or investments made by two or more private equity firms?

Under the recent changes to Romanian law, it is mandatory for all types of companies to include all binding covenants between the shareholders in the articles of association. An agreement contrary to the constitutive act would be null and void, and in light of the changes introduced, the shareholders cannot conclude private agreements. The only document governing their respective obligations is the constitutive act, and a contrary agreement can be interpreted as an amending act if it is registered at the Trade Register and the constitutive act is updated accordingly.

Usually, the constitutive acts of Romanian companies are exhaustive, including clauses for share transfer restrictions (right of first refusal mostly, which, in the case of limited liability companies, is also provided for by the law), exit rights, different voting majorities in case of decisional deadlock, the possibility of additional private funding, and drag-along and tag-along rights.

14 Limitations on transaction size

Do private equity firms have limitations on the size of transactions they may engage in?

Generally, the law prescribes no limitations on the size of transactions a company can engage in, unless otherwise stipulated by the constitutive act. The exceptions to this rule are pension funds, banks and insurance companies, which must comply with strict regulations in respect of investments, as explained in question 18. Obviously, all transactions must strictly observe the Competition Law (21/1996), and if the transaction value would exceed the thresholds indicated, they shall follow the procedure prescribed by the aforesaid law.

15 Exit strategies and investment horizons

How do the exit strategies and investment horizons of private equity firms affect the structuring and negotiation of leveraged buyout transactions?

Under Romanian law, leveraged buyout transactions are not regulated as such, therefore their scope and strategy are only a matter of negotiation and business skill.

16 Principal accounting considerations

What are some of the principal accounting considerations for private equity transactions?

Romanian accounting legislation has incorporated the International Accounting Standards; however, a detailed analysis of the implications for this field are beyond the scope of this report.

17 Target companies and industries

What types of companies or industries have typically been the targets of going-private transactions? Has there been any change in focus in recent years?

In the past decade, many going-private transactions have taken place as a result of privatisation. Initially, state-owned companies were reorganised as *régies autonomes* and stock companies. Once the latter had been privatised, many of these companies were delisted. For example, the concrete industry is now completely privatised, while other industries, such as banking and pharmaceuticals, are currently undergoing privatisation.

18 Industry-specific regulatory schemes

Do industry-specific regulatory schemes limit the potential targets of private equity firms?

As stated above, there are strict rules that apply to certain industries. For instance, pension funds, insurance companies and banks are all subject to strict limitations concerning the principles to apply in their activity, the types of investments they can opt for and the size of the investment itself. This careful regulation is motivated by the fact that, unlike the other entities, they have a declared mission to multiply the amounts received from contributors to be able to reimburse the contributors according to a scheme (interest, pension, insurance premiums).

Update and trends

The Romanian legislation on commercial companies and on capital markets does not provide any specific rules for private equity transactions. The general provisions regulated by the legislation were not modified or amended by the recent legislative changes and, consequently, the regime of private equity transactions remained the same.

19 Cross-border transactions

What are the issues unique to structuring and financing a cross-border going-private or private equity transaction?

As is the case of any country, investors can take advantage of tax treaties which might offer a preferential tax regime to entities from the other contracting parties. Further, the tax legislation levies a special withholding tax on interest, of up to 16 per cent, if the beneficiary is a legal person residing in the European Union or a permanent establishment of such entity in another member state.

20 Club and group deals

What are the special considerations when more than one private equity firm (or one or more private equity firms and a strategic partner) is participating in a club or group deal?

Romanian company law simplifies this issue by granting voting rights proportionally with the shares owned (one share, one vote), together with the obligation that, when the investor companies' boards of directors decide on the acquisition of shares in the target company, they must include the contribution in capital on one hand, and the contribution in profits and losses (which might differ). This way, each member of the group has a number of votes that everyone knows from the beginning and an eventual decisional deadlock is avoided.

21 Recent credit market disruptions

How have disruptions in the credit markets affected dealmaking? What specific changes to transaction terms have you seen and do you expect in the future?

The Romanian credit markets have been affected by the international financial crisis, but only to a certain degree, taking into consideration that the international crisis had only an indirect effect. As the Romanian banks do not have large US exposures, the international crisis is not directly affecting the Romanian credit markets. The negative effect of the international crisis is being felt by the Romanian credit markets as the lack of liquidity is more severe.

In this national and international context, interest rates have significantly been raised and consequently, the credit conditions have become more difficult. The interest rate rise is the result of the increase of credit costs and because interbanking credits are no longer given unless very strict conditions are complied with.

The banks have become more strict and selective in financing, hence obtaining financing currently is a challenge, even when guarantees are offered. The majority (of analysts) believe that only the clients with a great need for financing will be seriously affected by the new credit conditions.

Recently, the Romanian National Bank adopted several norms and regulations that are meant to offer financial stability for interest rates and to avoid the tougher conditions imposed by the credit institutions.

The financial market is registering the same negative fluctuations. The Bucharest Stock Exchange fluctuated dramatically in the most recent financial period, and on several days it was closed as stocks were dropping alarmingly.

The new market conditions make managers' work more difficult as, from now on, they must pay special attention not only to the gains but also to the future financing possibilities.

Financial analysts are predicting an increase in the cost of credit in the immediate future.

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