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Private Equity

in 33 jurisdictions worldwide

Contributing editor: Casey Cogut

2011

Published by
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Advokatfirman Delphi
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Private Equity 2011

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Private Equity 2011
Published by
Law Business Research Ltd
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Tel: +44 20 7908 1188
Fax: +44 20 7229 6910
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ISSN 1746-5524

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Printed and distributed by
Encompass Print Solutions
Tel: 0844 2480 112

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

Private equity transactions in South Africa are as varied as they are in other jurisdictions. Generally, they can be classified into three categories, namely venture capital, development capital and buyouts. Typically, partnerships (usually en commandite or limited liability), trusts and companies are the most common legal structures used as vehicles for private equity investments. In addition, captive funds of financial services players, such as insurers, play an important role in the country's private equity industry. Collective investment scheme structures might sometimes be utilised where it is possible to accommodate the relevant regulatory requirements. Certain investors (eg, pension funds) are entitled to specific and often beneficial tax treatment, in which event the transaction is structured so that gains 'flow' through the investor, so that the fund entity is 'tax-transparent'. Private equity transactions are funded by equity or debt or a combination of both. Sources of funding generally include independent private equity firms, banks, government or development funding institutions and institutional investors, including pension funds, endowments and insurance structures. Investors in private equity funds will generally derive a return in the form of dividends, interest, proceeds from the sale of shares, initial public offering or recapitalisation.

The majority of transactions concluded by the private equity industry in South Africa have a significant black economic empowerment (BEE) component; indications are that this will continue to be the case in the future. BEE is a statutory policy designed to facilitate greater economic participation for black, historically disadvantaged individuals through the acquisition of equity ownership or management of an investee company (or both). BEE is an important factor to consider when structuring private equity transactions. In addition, BEE transactions themselves represent a significant class of private equity transactions.

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?

There are a number of legislative and regulatory schemes that govern private equity activities as with other corporate transactions. In addition to the BEE policy framework, private equity transactions must take cognisance of the Companies Act, 1973 (the Act) as well as the New Companies Act, 2008 (the New Companies Act), which will replace the current Act later this year; and, further, the King Report on Governance for South Africa (2009) and the King Code of Governance Principles (King III); the Securities Regulation Code on Takeovers and Mergers and the Rules of the Panel (the Takeover Code); and the JSE Listings Requirements (the Listings Requirements), to name a few, as well as legislation regulating exchange controls, competition and anti-trust activity. Corporate governance will be affected by changes introduced by the New Companies Act, in addition to King III. The New Companies Act is expected to come into force during the second quarter of 2011 and will replace the current Act in its entirety. The New Companies Act addresses various aspects including incorporation, registration, organisation and management of various kinds of companies as well as providing for more equitable and efficient amalgamation, mergers and takeovers of companies. The New Companies Act further codifies director's fiduciary duties, which are currently governed by common law, and seeks to promote transparency and higher levels of corporate governance and accountability. The Takeover Code will be amended with the introduction of the New Companies Act to reflect amendments relating to the regulation of takeovers and mergers. It is also expected that the draft takeover regulations will be finalised by mid-2011.

The New Companies Act retains the recent amendments to the current Act, including the ability of companies to provide financial assistance as part of private equity transactions, particularly common in BEE transactions, if such company's board is satisfied that, subsequent to the transaction, the consolidated assets of the company fairly valued will exceed its consolidated liabilities and that subsequent to providing financial assistance, and for the duration of the transaction, the company will be able to pay its debts as they become due in the ordinary course of business. The terms upon which the financial assistance is to be given must also be sanctioned by a special resolution of the shareholders of the company. A special resolution requires shareholders holding at least 25 per cent of the votes to be present in person or by proxy at the meeting in question, with the resolution approved by 75 per cent of the votes of those shareholders present in person or by proxy.

The New Companies Act further allows a company to provide financial assistance in connection with the subscription for any securities to be issued by the company or a related or inter-related company, or for the purchase of any securities of the company or a related or inter-related company if the company's board is satisfied that, subsequent to the transaction, the solvency and liquidity tests will be satisfied and the terms under which the financial assistance is to be provided are fair and reasonable to the company. The allowance of financial assistance under the Act and the New Companies Act has thus far been and will continue to be subject to compliance with shareholder and board approvals, facilitated BEE transactions, especially where third-party funding was expensive.

The main advantages of going private are that financial disclosure obligations and the administrative costs and burdens that apply to a public company are reduced. A private company, for example, is, at present, not obliged to file its annual financial statements with the registrar of companies. There are also less onerous corporate governance and financial reporting obligations that apply to a private company.

If, following a private equity transaction, a company remains public or becomes a public company, the Act requires the company to:

- prepare its financial statements in accordance with international financial reporting standards;
- distribute half-yearly interim financial reports to every shareholder;
- appoint an audit committee comprising at least two non-executive independent directors; and
- identify the individual auditor at the audit firm appointed, who will be the designated auditor of the company. This person may not be appointed as such for more than five consecutive years.

Every company will be required to file its annual return with the Companies and Intellectual Property Commission and to prepare annual financial statements no more than six months after the end of its financial year. The annual financial statements will have to be audited in the case of a public company, and in the case of a private company will have to be audited if required by the regulations to be promulgated in the terms of the New Companies Act. Alternatively, in the case of a private company, annual financial statements may be audited voluntarily at the option of the company or may be independently reviewed in terms of the regulations. The New Companies Act prescribes the nature of the information that must be included in a company's annual financial statements.

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 members of the board are participating or have an interest in the transaction?

The main issue facing boards of directors of public companies is ensuring that directors exercise their common law fiduciary duties towards the company. These fiduciary duties include the duty to exercise independent judgment, the duty to avoid conflicts of interest and the duty to act in the best interests of the holders of the securities in the company. In particular, the conflict of interest that some directors may have between their personal interest as purchasers of the company and their duty to act in the best interests of the company – avoiding the exploitation of any property, information or opportunity of the company – needs to be properly managed by the board. This conflict of interest is typically dealt with and managed through the establishment of a special committee of the board. The committee would typically be chaired by the independent chairperson of the company and would be mandated to run the private equity transaction on behalf of the company. Those directors who have a direct or indirect interest in the buyout would not be members of the committee but could be called upon by the committee to assist where necessary. The Act imposes strict disclosure requirements on directors in respect of transactions in which they have a direct or indirect interest.

In terms of the Takeover Code, the directors of an acquiring and target company must, in advising the holders of relevant securities, act only in their capacity as directors and not have regard to their personal or family shareholdings or to their personal relationships with the companies. The interests of holders of relevant securities taken as a whole must be considered most important when the directors are giving advice to such holders.

The New Companies Act codifies most of the director's fiduciary duties and provides more detailed and in certain respects stricter provisions relating to standards of conduct for directors, the liability of directors and the indemnification of directors from liability for conduct in breach of certain provisions of the New Companies Act.

4 Disclosure issues

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

Private equity transactions are subject to the general disclosure requirements prescribed by South African law. Although there are no specific disclosure requirements for private equity transactions, if a party involved in the transaction is a listed company then the general disclosure requirements applicable to listed companies, as well as the requirements of the Takeover Code and the Listings Requirements, will have to be met.

The Listings Requirements require the issuing of cautionary announcements when transactions are contemplated that may affect the price of the shares of the target company or the acquiring company. This is in addition to various other disclosure requirements that are not specific to private equity transactions.

The Takeover Code, which regulates 'affected transactions' (transactions resulting in a change of control of the target company – as defined in the Takeover Code), requires the parties to an 'affected transaction' to comply with a prescribed standard of conduct in respect of matters such as the form and conduct of offers, the announcements, mandatory offers, asset valuations, equal treatment of shareholders and the disclosure of information. It is possible to obtain exemption from compliance with the provisions of the Takeover Code, although such exemption is not lightly granted. In certain cases, the Securities Regulation Panel will consider waiving compliance with the Takeover Code in favour of the application of an equivalent takeover code of an acceptable jurisdiction, such as where the target is an external company with a local secondary listing and the transaction is subject to the equivalent of the Takeover Code in the jurisdiction of the primary listing.

The New Companies Act regulates affected transactions and offers and prescribes disclosure requirements concerning certain share transactions. In terms of the New Companies Act, a person must notify a regulated company within three days after he or she:

- acquires a beneficial interest in sufficient securities of a class issued by that company such that, as a result of the acquisition, the person holds a beneficial interest in securities amounting to 5 per cent or any further whole multiple of 5 per cent of the issued securities of that class; or
- disposes of a beneficial interest in sufficient securities of a class issued by a company such that, as a result of the disposition, the person no longer holds a beneficial interest in securities amounting to a particular multiple of 5 per cent of the issued securities of that class.

Upon receipt of the notice, the company is under an obligation to file it with the Takeover Regulation Panel (to be established in terms of the New Companies Act) and report the information to the holders of the relevant class of securities unless the notice concerned a disposition of less than 1 per cent of the relevant class of securities.

5 Timing considerations

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

Depending on the nature of the transaction, the general negotiation and implementation of the transaction may take several months, particularly when sophisticated or complex structures are used or if regulatory approvals (such as exchange control or competition) are required.

When delisting is involved, the delisting procedure would itself require 17 calendar days from the time a complete application has been lodged with the JSE Limited (the JSE). This does not include the time required to implement the pre-application steps. In the case of category 1 transactions, the shareholders must approve the transaction in a general meeting. This could add several weeks to the timing of the transaction.

When the offeror makes a firm intention to acquire the securities of the offeree company, the Takeover Code requires the board of the offeree company to advise the holders of the relevant securities of its views on the offer within 14 days of the publication of the offer document. The offer must be open for at least 14 days after the posting of this document. Provision is also to be made for extensions and for time periods in respect of offers becoming unconditional as to acceptances. Without the consent of the panel, an offer may not be declared to be unconditional as to acceptances after midnight of the 60th day after the day the initial offer document was posted. A press release must be made before 5pm on the 60th day after the day the initial offer document was posted as to whether the offer is unconditional or has lapsed. All other conditions must be fulfilled within 21 days of the later of the first closing date or the date on which the offer becomes unconditional as to acceptances. Consideration must be posted within seven days of the later of the date of the offer becoming or being declared unconditional or the date of acceptance. A revised offer must be kept open for at least 21 days after the date on which the revised offer document is posted. The Takeover Code requires an offeror to make an announcement, and simultaneously inform the Securities Regulation Panel and the JSE, before 9am on the fourth business day following the day on which an offer is due to expire, it becoming or being declared unconditional, or is extended. The announcement must specify the acceptances of the offer that have been received, the securities and rights over securities held before the offer period and the securities and rights over securities acquired or agreed to be acquired during the offer period. An offer document must be posted within 30 days of the announcement of a firm intention to make an offer.

In terms of the Competition Act 1998, the Competition Commission (the Commission) has 20 business days in which to investigate an 'intermediate merger' (which meets the relevant thresholds of assets and turnover set out in the Competition Act) and to approve it without conditions, approve it conditionally or prohibit the transaction entirely. If the Commission has not reached a decision by the end of the initial period of 20 business days, the time frame may be extended for a further 40 business days.

If a transaction is categorised as a 'large merger', the Commission has 40 business days in which to assess the transaction and refer its recommendation to the Competition Tribunal (the Tribunal). The Commission may apply to the Tribunal for an extension of the 40-business day period. This period may be extended further, but only by 15 business days at a time. Upon receiving the recommendation of the Commission, or upon expiry of the applicable time period, the Tribunal will set a date for a hearing in relation to the transaction. There is no specific time frame for the period between the recommendation by the Commission and the date of the hearing of the Tribunal. This will depend on the caseload of the Tribunal at any given time.

In the case of a scheme of arrangement under the Act and the New Companies Act, the time frames prescribed by the courts in authorising the scheme will have to be complied with.

Where the approval of the exchange control department of the South African Reserve Bank (exchange control) is required, timing considerations will depend on the complexity of the transaction and the specific approval required. Generally, applications to exchange control will require at least six to eight weeks to be processed. Generally, exchange control approval is required in respect of transactions that require the outflow of capital from South Africa or create obligations on South African-resident companies in favour of non-resident entities. Outward investments by South African private equity funds are also subject to exchange control approvals, to the extent that they do not fall within the ambit of recently relaxed exchange control regulations relating to investments into the rest of Africa (see question 18).

6 Purchase agreements

What purchase agreement provisions are specific to private equity transactions?

In South Africa, due diligence, warranties, disclosure issues, insolvency protection and regulatory approvals are important aspects of the negotiation of purchase agreements. There is a close interrelation between due diligence, warranties and disclosure aspects.

Minority protection provisions in an existing shareholders' agreement may render the purchase agreement subject to the approval of the minority shareholders. This is sometimes obviated by the drag-along provisions in shareholders' agreements.

Where there is a distinction between the registered and the beneficial owner of shares in the target company, appropriate contractual provisions must be negotiated to ensure that the registered owner gives effect to the provisions of the share purchase agreement.

Reverse break-up fees are rarely encountered but are occasionally provided for where the acquiring party is subject to certain uncertain future events that may in the contemplation of the parties prevent the transaction from being completed. Sometimes options (whether in conjunction with full transaction agreements or not) are used to achieve this end. There seems to be resistance in the market to proliferation of reverse break-up fees and it is unclear whether they will become more common in future. Certain financial houses have taken a more flexible approach to break fees and reverse break fees. It is unclear whether this will become a trend in the South African private equity sphere.

The issues relating to limitations on remedies for breach apply to purchase agreements of a private equity nature and purchase agreements in general. Agreements sometimes provide for claims based on a breach, particularly breach of warranty, to be made within a specific time period and for the amount claimed to be capped. Sometimes claims are disallowed if they do not reach an agreed threshold, individually and/or in aggregate. Insurance is available in respect of claims of this nature. Private equity funds that are active in the distressed companies sector should be aware that liquidators are usually not prepared to provide warranties in relation to the target company.

Indemnity clauses are usually a matter of bargaining strength. They are often encountered in connection with undisclosed liabilities pre-dating the acquisition date and sometimes also in connection with disclosed liabilities where the quantum of the liability is not known. Tax indemnities in respect of taxation not provided for in the target's financial statements are common. Indemnities are sometimes subject to minimum thresholds and sometimes per claim and aggregate caps and time limits are agreed. In regulated industries (such as financial services), indemnities in connection with regulatory breaches are common.

Covenants to assist in raising finance are rare.

Complex financial conditions are not necessarily encountered in the agreements documenting the private equity transaction itself, but are often found in the finance agreements between the acquiring party and the financing banks. Banks generally require adequate security to be provided and in certain cases cession of receivables is required to bulk up the available security. Provisions dealing with minimum debt-servicing ratios and repayment triggers are commonplace.

Where exchange control approval is required it would usually have to be dealt with as a condition precedent, as agreements entered into in contravention of the exchange control laws are at risk of being void ab initio.

7 Participation of target company management

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

In South Africa, the phrase 'going private' is understood to refer either to transactions that involve delisting from the JSE or to transactions in which a company converts from a public company into a private company.

There are generally no legal restrictions in respect of management participation. Management participation may be in the form of its involvement in the new ownership structure through specific employment arrangements, participation in employee share incentive schemes, or a combination of the two.

Private equity transactions in South Africa often involve a 'lock-in' of the existing management of the target company in order to retain management expertise for existing business and for the development of new business, particularly in industries such as the financial services sector where reputation, relationships and proven business expertise are critical for client retention. Management lock-ins are commonly effected through retention bonuses or, where management has been given equity participation, as a staggered transfer of shares, for example in BEE transactions where the option to acquire specified tranches of shares is conditional upon continued employment, sometimes coupled with performance triggers.

The retention of skilled management may also be achieved by concluding non-compete agreements with the relevant members of management.

Traditionally, issues regarding remuneration of management become important in private equity transactions that involve conversion of the target company from a public into a private company since different standards of remuneration are applied to public companies as opposed to private companies. In order to ensure the retention of management following a target company 'going private', innovative packages need to be offered to management, which may include stock options.

The Takeover Code and the Listings Requirements are also relevant in the context of 'going private' transactions. The Takeover Code applies to 'affected transactions' – transactions which result in 35 per cent or more of the voting rights of inter alia public companies being exercisable by a different person or persons – and prescribes that the offer document must specify whether and in what manner directors' emoluments will be affected by the acquisition of the offeree (target) company or by any other associated transaction. In addition, disclosure must be made of any agreement or understanding with any connection with or dependence on the offer existing between the offeror or any person acting in concert with it, on the one hand, and any of the directors of the target company, on the other. The Takeover Code also provides that the first circular from the target company to the holders of the relevant securities must disclose the material particulars of the service contracts of any director or proposed director of the target company, including disclosure of any amendments to such contracts within the six months prior to the date of the circular. Draft takeover regulations, to be promulgated in terms of the New Companies Act, have been published for public comment but are expected to be finalised by mid-2011.

The Listings Requirements in turn classify transactions into categories 1 and 2, depending on the percentage ratio of the transaction. The percentage ratio is determined with reference to the consideration-to-market-capitalisation ratio, the dilution factor or, in the case of settlement partly in cash and partly by the issue of shares in the acquiring company, a combination of the two. The relevance of these categories is that, for the purposes of category 1 transactions, details pertaining to the contracts of service of the directors, be they current or prospective, of the listed company involved must be sent out in a circular to shareholders.

In BEE transactions, where shares are to be issued to employees who qualify as BEE participants, there may be pressure to issue shares to all employees and not only to the employees qualifying as BEE participants. This is typically achieved by transferring shares to a trust created for the benefit of the employees rather than by issuing shares directly to employees. Financial assistance can be given to the trust for purposes of the acquisition of shares without the issuing company first having to comply with liquidity and solvency requirements.

Question 8 deals with some of the tax considerations pertinent to the matters discussed above.

8 Tax issues

What are the basic tax issues involved in private equity transactions? Give details regarding the tax status of a target, deductibility of interest based on the form of financing and tax issues related to executive compensation. Can share acquisitions be classified as asset acquisitions for tax purposes?

South Africa applies a residence-based income tax system in terms of which South African residents are taxed on their worldwide income and non-residents are subject to income tax on income derived from a South African source or a deemed South African source. Residents are also subject to capital gains tax (CGT) on capital gains arising from the disposal of their worldwide assets, while non-residents are subject to CGT on capital gains arising from the disposal of immoveable property situated in South Africa or any interest or right in immoveable property situated in South Africa, as well as in respect of the disposal by the non-resident of any asset that is attributable to a permanent establishment (PE) of that non-resident in South Africa.

Funding of acquisitions

Private equity transactions often make use of debt. No tax deduction is given for interest paid on loans incurred to purchase shares, whereas interest on loans incurred to purchase the underlying assets of a company is deductible for income tax purposes. The deductibility of interest expenditure depends primarily on whether the interest expense was incurred in the production of 'income' as required by the Income Tax Act, 1962 (ITA). Dividend income is exempt from tax and is not income as defined.

To ensure that interest is tax-deductible, 'debt pushdown' structures are often utilised. After the acquisition of the shares in the target company by the local holding company, the assets of the target company are transferred to a new subsidiary of the holding company, which takes out a loan for the acquisition of the assets. The interest on the money borrowed by the new subsidiary to acquire the assets is generally tax-deductible. The proceeds of the sale of the assets are distributed to the holding company, which uses the amounts to repay the debt that was raised to purchase the shares.

The ITA contains specific provisions that provide tax rollover relief for restructuring transactions. The transfer of the assets under the debt pushdown structure should qualify for the tax rollover relief. In general, the provisions provide a rollover or deferral of any tax payable by the target company arising from the disposal of its assets to another company that is part of the same group of companies. The tax deferral is provided for in respect of certain types of qualifying transactions, such as asset-for-share transactions, amalgamation transactions and intra-group transactions. In terms of one of these provisions, the transfer of the assets under the debt pushdown structure should qualify for the tax rollover relief. Accordingly, where the provisions apply the target company will not pay tax when it sells its assets to the new company at market value, which has to borrow money to purchase the assets. However, it must be kept in mind that these provisions provide for a deferral of tax and not for an exemption. Certain trigger events may have negative tax consequences, for instance where the transferee company ceases to be a part of the same group of companies as the transferor company within a six-year period, or if the asset is sold within an 18-month period after the restructure.

If the acquisition is financed by loans from a non-resident connected person, the deductibility of the interest will be restricted under the transfer pricing and thin capitalisation rules of section 31 of the ITA. The transfer pricing and thin capitalisation rules are in the process of amendment. However, in terms of the current rules the South African Revenue Service (SARS) applies a safe harbour ratio of shareholders' debt to equity of 3:1. It is not certain whether this debt-to-equity ratio will continue to apply under the amended transfer pricing and thin capitalisation rules.

Interest is generally subject to income tax in the hands of a resident recipient, but in terms of section 10(1)(h) of the ITA, interest received by a non-resident is exempt from income tax unless the non-resident at any time during the year carried on business through a permanent establishment in South Africa.

Dividends declared by a South African company are as a general rule exempt from income tax. However, a resident company declaring a dividend is currently subject to secondary tax on companies (STC) at a rate of 10 per cent on the net amount of dividends declared. STC is due to be replaced by a dividend withholding tax (DWT), also at a rate of 10 per cent. Although the legislation dealing with DWT has already been promulgated, it will only come into effect in April 2012. As STC is not a tax on shareholders but a tax on companies declaring dividends, the STC rate is not reduced by the relevant articles of double tax agreements (DTAs) entered into by South Africa although some DTAs provide relief in respect of the tax. The DWT, on the other hand, is a tax on the shareholder and the rate could thus be reduced where a non-resident shareholder is resident in a treaty country with a DTA that provides for a reduced rate of less than 10 per cent in respect of dividends.

Taxation of proceeds on disposal of shares in target company

In general, shares could be held either as capital assets or as trading stock, depending on the intention of the shareholder as evidenced by the facts. Profits realised on the disposal of shares held as trading stock are subject to income tax, while the gains realised on the disposal of shares held as capital assets are subject to CGT.

In view of the uncertainty as to the intention of a shareholder, the legislature introduced a safe harbour rule under section 9C of the ITA for both listed and unlisted shares in terms of which profits from the sale of shares that have been held for at least three years will be regarded as being capital in nature and thus only be subject to CGT and not income tax. This does not mean that the proceeds on the disposal of shares held for less than three years will automatically be of a revenue nature – depending on the circumstances, such proceeds may still be regarded as capital in nature.

CGT is imposed on South African resident companies at an effective rate of 14 per cent, which is significantly lower than the income tax rate of 28 per cent. However, in both instances, if the company declares the profits as dividends, it will be subject to STC at a rate of 10 per cent.

A non-resident will be subject to income tax in respect of the profits realised from the disposal of shares held (in a South African company) as trading stock, unless DTA protection applied. A non-resident will be subject to CGT in respect of profits realised from the sale of shares held as capital assets if the non-resident held at least 20 per cent of shares in a company which held immoveable property, comprising at least 80 per cent of the value of the shares held in the company or if the shares were attributable to a PE of that non-resident in South Africa.

To reduce the risk that a local fund manager may create a PE for non-resident investors of a private equity fund conducted via a limited partnership or trust, the legislator has restricted the definition of a PE in the ITA (as defined in article 5 of the OECD Model DTA) to disregard the activities of the partnership or trust in South Africa in respect of financial instruments in considering whether the foreign investors had a PE in South Africa.

Executive compensation

The tax consequences of executive compensation schemes are governed by section 8C of the ITA. The application of section 8C may have the effect that management will be required to pay income tax (at the maximum rate of 40 per cent) either when an unrestricted equity instrument is received by virtue of employment or when any gains are made as a result of the vesting of restricted equity instruments that are acquired by virtue of their employment. Vesting occurs when a restricted equity instrument becomes freely disposable. Equity instruments include options, shares, any financial instrument convertible to a share, or contractual rights or obligations the value of which is determined directly or indirectly with reference to a share. Section 8C may impact on management equity ownership schemes where the management is locked in, even if the management vehicle has participated on a fully funded basis (if, that is, they have paid market value for their shares). When structuring contractual relationships with and equity investments by management, expert tax advice should be obtained in this regard.

Carried interest

Carried interest is typically derived in the form of a share of the gains from the disposal of shares by the private equity fund. The question arises whether the gains in question are of a revenue or capital nature. However, there is uncertainty in South Africa regarding the tax treatment of the carried interest. If such gains qualified under the safe harbour provisions of section 9C and did not fall within the scope of the provisions of section 8C, they would generally be taxed at CGT rates. The issue has been under consideration by SARS and the National Treasury for some time. The South African Venture Capital Association (SAVCA) has approached SARS and the National Treasury to obtain certainty in this regard, but no decision has yet been reached.

Venture capital company incentive

In order to encourage equity finance investment by small and medium-sized businesses, a new incentive was introduced in section 12J of the ITA in 2008. Natural persons, listed companies and controlled group companies in relation to listed companies ('investors', as contemplated in the definition of a group of companies in section 41 of the ITA) may now deduct expenditure actually incurred in acquiring shares issued by a venture capital company (VCC), subject to the conditions and limitations set out in section 12J. Non-company structures do not qualify as VCCs.

To qualify as a VCC, and thus allow investors to claim the deduction, the company in question has to comply with certain requirements. For example, the company must be a resident, must not be a controlled group company and must be an unlisted company (as defined in section 41 of the ITA) or junior mining company. Section 12J also sets out criteria regarding the target companies in which the VCC may invest (qualifying companies). A VCC may invest only in companies that do not carry on impermissible trades as defined in section 12J. In addition, the VCC must spend at least 30 million rand to acquire shares in qualifying companies or, where the VCC acquires shares in a junior mining company, at least 150 million rand. Furthermore, it must invest at least 80 per cent of the funds in qualifying shares in companies that hold assets with a book value of not more than 10 million rand – or, if such company is a junior mining company, not exceeding 100 million rand – and must not invest more than 15 per cent of invested funds in any one qualifying company.

Approval as a VCC may be withdrawn should the VCC fail to comply with the requirements of section 12J(5) of the ITA, in which event an amount equal to 125 per cent of the expenditure incurred by the investor will be included in the income of the VCC.

Headquarter companies

In recognition of South Africa's economic position in Africa, the legislature has amended the ITA to establish South Africa as a holding company gateway into Africa. The objective sought to be achieved by the amendments is the removal of what are considered to be significant barriers to South Africa's role as an ideal holding company jurisdiction. In order to remove the identified barriers, the legislature proposes to introduce a regional holding company regime (the concept of a headquarter company into the ITA) that will entitle qualifying holding companies to tax relief in South Africa. The amendments will apply with effect from 1 January 2011.

In order for a company to qualify for the proposed tax relief, it must satisfy the requirements of the definition of a headquarter company. These are:

- it must be a South African resident company;
- for the duration of the current tax year and all previous tax years, each shareholder (whether alone or together with any other company that forms part of the same group of companies as the shareholder) must have held at least 20 per cent of the equity shares and voting rights in the company;
- at the end of the current tax year and all previous tax years, at least 80 per cent of the cost of the total assets of the company must be attributable to any interest in equity shares in; any amount loaned or advanced to; any intellectual property that is licensed to any foreign company in which the company (whether alone or together with any other company forming part of the same group of companies as the company) held at least 20 per cent of the equity shares and voting rights; and
- at least 80 per cent of the total receipts and accruals of the company for the current year must consist of any dividend, interest, royalty or fee paid or payable by the foreign company or proceeds from the disposal of any interest in equity shares in or any intellectual property licensed to the foreign company.

9 Existing indebtedness

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

The manner in which existing indebtedness is addressed depends on the nature of the transaction and is not treated uniformly for the purposes of all private equity transactions. In BEE transactions, existing indebtedness is not necessarily an important consideration. In other transactions, where third-party indebtedness exists, borrowing limits, debt-to-equity, debt-to-asset or debt-to-turnover ratios and financial covenants are commonly scrutinised. Transactions involving internal indebtedness (which may take the form of shareholder loans) can be dealt with either by subordination of the indebtedness or the back-prioritisation of the loans, which may include an undertaking by the shareholder of the target company not to make any claim in respect of such indebtedness on insolvency. The writing-off of shareholder loans is sometimes considered. The default position is usually that the acquiring party takes cession of the shareholder loans (which may be at a discount to face value in certain cases).

Where the transaction affects the security of creditors, it may be necessary to refinance the existing debt by providing replacement debt for existing indebtedness although, in the current financial climate, the equity component of acquisitions is generally higher than was the norm during the first half of the decade. This applies equally to the refinancing of target companies.

Please also refer to question 8 for an overview of when interest on debt qualifies for deduction from income.

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? Are there any other restrictions in your jurisdiction on the use of debt financing for private equity transactions?

The distinction between private equity funds that are captive funds and those that are independent funds impacts on the financing arrangements of private equity transactions. Captive funds arrange finance for private equity transactions through their internal sources of funds and various internal treasury arrangements. No specific financing methods are used by independent funds: the financing structures range from straightforward combinations of equity and debt financing to complex financing structures involving tiered multilateral arrangements. Financing of private equity transactions through borrowed funding generally attracts interest rates commensurate with the perceived risks and, due to their unique risk profile, borrowings for BEE transactions tend to attract particularly high interest rates. Preference share structures are sometimes used to reduce the cost of funding since a lower coupon rate can generally be negotiated due to the dividends received by the funder being tax-free.

Following the scrapping of the capital maintenance rule in favour of solvency and liquidity tests, the provision of funding by the target company itself is now generally possible in terms of both the current Act and the New Companies Act.

Foreign involvement in private equity transactions is subject to exchange control approval. More specifically, cross-border debt will require exchange control approval with respect to repayment terms, interest rates, security and the like. Interest on foreign debt at a rate higher than the base rate applicable to the currency of the debt will only be permitted in exceptional circumstances. Margin loans generally do not play a prominent role in the South African private equity market, although they can play a role in enabling a private equity fund to build a stake in the target prior to making a formal offer.

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?

Going-private transactions usually involve a combination of debt and equity financing; further details of this are provided in question 10. The traditional role of banks as providers of funding has to a certain extent been eroded by the availability of funding through institutional investors. In addition, banks have historically been averse to taking an equity stake in the transactions that they finance. The major local banks have separate private equity arms that are prepared to depart from the traditional banking stance. This is not invariably the case, however, and departures from the norm are commonplace. The basic funding structure is usually set out in the acquisition agreement, with more detailed provisions in the shareholders' agreement, loan agreements and associated security agreements. In more complex structures, funding guarantees, inter-creditor agreements and derivatives may play an important role. Preference share structures are also often encountered, with the bank or an associate of the bank subscribing for preference shares instead of providing conventional loan funding. Where the funder is in a particularly strong bargaining position, the preference shares can be made convertible into ordinary shares upon a failure by the borrower company to redeem the preference shares. Where the total number of issued ordinary shares is only a fraction of the number of preference shares, the resultant dilution of the existing holders of ordinary shares effectively allows the funder to take control of the borrower company. These structures may in certain cases provide tax advantages. Parastatal funding agencies play a significant role in financing certain classes of private equity transactions, with such funding being linked, as a rule, more to the potential socio-economic benefit of the investments than to commercial returns, which in turn often leads the parastatal to demand participation in the running of the borrower company so as to ensure that the contemplated socio-economic gains are achieved.

12 Fraudulent conveyance and other bankruptcy issues

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

Although this has never been a contentious issue for the purposes of the South African private equity market, the provisions of the Insolvency Act, 1936 (the Insolvency Act), which allow certain dispositions to be set aside on liquidation of a company (among other matters), apply with equal force to private equity transactions. These include dispositions not for value, voidable preferences, undue preferences and collusive dealings.

A disposition not for value may be declared void if made within the two years prior to the date of liquidation of the debtor company and if the beneficiary of the disposition is unable to prove that, immediately after the disposition, the assets of the company in liquidation exceeded its liabilities. In the case of a disposition not for value made more than two years before liquidation the onus is reversed, and will be voidable only if the liquidator can prove that the liabilities of the company in liquidation exceeded its assets immediately after the disposition.

A voidable preference includes a disposition by a company in liquidation made within the six months prior to the date of liquidation that has the effect of preferring one creditor over another if, immediately after the disposition, the liabilities of the company exceeded its assets – unless the disposition was made in the ordinary course of business and was not intended to prefer one creditor over another.

An undue preference is a disposition by a company intended to prefer one creditor over another at a time when the liabilities of the company exceed its assets.

Collusive dealings relate to transactions between a company and a third party that prejudice the creditors of the company or prefer some of them over others, in the knowledge that the company is insolvent and with the expectation that the creditors of the company will be prejudiced or that some creditors will be preferred over others.

In addition, section 34 of the Insolvency Act provides that if a trader (a term that is very widely defined) sells or disposes of its business or assets and does not publish a notice of such sale or disposal, first in the South African Government Gazette and secondly in two editions of an Afrikaans newspaper and two editions of an English newspaper circulating in the district where the sale took place, by not later than 30 days and not earlier than 60 days prior to the effective date of the transfer, the transfer will be 'void' as against creditors for a period of six months afterwards. In practical terms, this means that if the sale is not advertised as required, and the seller has unpaid debts, the seller's creditors can, for a period of six months after transfer, attach the sold assets/business in the hands of the buyer. In addition, if the seller is liquidated within six months of the transfer, the liquidator has an election to declare the sale void and claim back the assets or business from the purchaser, leaving the purchaser with an unsecured, concurrent claim for repayment of the purchase price. Thus, if the decision is made not to advertise the sale as required, a purchaser should obtain extensive indemnities from the seller, coupled with a deferment of payment of the purchase price or retention of at least a portion of the purchase price in escrow, ideally until expiry of the six-month period.

In addition, the Insolvency Act, the New Companies Act (which is not yet in force – see question 2 for more detail) will introduce a new form of bankruptcy into South African Insolvency law: Business Rescue. The New Companies Act will permit the Business Rescue practitioner to suspend contractual obligations or entire contracts (or with court permission to cancel such contractual obligations or entire contracts) simply because they are commercially onerous and there is no need to establish that the obligations or contracts are fraudulent or impeachable.

Fraudulent conveyance issues are often not dealt with separately in the transaction agreements. In practice, they are usually dealt with in the course of the negotiation of warranties that would cover the prospect of the transaction being set aside (including solvency warranties, warranties in respect of the right to transfer title and warranties in respect of the rights of third parties) and the associated indemnities. As is the case in most other jurisdictions, South African private equity funds, particularly independent funds, are generally loath to give warranties. However, if a due diligence investigation reveals specific areas of concern in this regard, tailor-made warranty and indemnity clauses will usually be negotiated. In addition, where real areas of risk have been identified, it is likely that certain retentions in respect of the purchase price will be provided for.

13 Shareholders' agreements

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

Shareholders' agreements in the context of private equity transactions often have complex arrangements relating to the control of the target company, especially in BEE transactions where the target company may have a well-entrenched control structure. BEE legislation, however, requires a transfer of management powers and commercial benefit in addition to bare ownership and, in practice, sophisticated control structures are put in place. Measures that dilute the management and control powers of the BEE partner will usually impact negatively on the BEE rating of the target.

Shareholders' agreements almost invariably contain a full suite of minority protections. This involves a combination of drag-and-tag clauses, pre-emption rights, transfer restrictions, reserved matters and warranties.

Dispute resolution sometimes raises difficult questions and mechanisms for the resolution of deadlocks are subject to fierce negotiation. Although arbitration is commonly used to resolve the deadlock, the application of arbitration in the context of commercial decisions that require buy-in of the parties to the dispute has been the subject of criticism, leading to the inclusion of deadlock-breaking provisions involving binding decisions by independent experts knowledgeable in the field relevant to the dispute, as well as more robust remedies such as Russian roulette and Texas shoot-out provisions.

Shareholders' agreements usually provide for referral of corporate opportunities to the company and often contain comprehensive non-compete clauses. Restrictions are frequently placed on the transfer of shares to a competitor of any of the shareholders.

Exit strategies commonly encountered in South Africa include trade sales, listings on the JSE, management buyouts (currently less popular due to the difficulty of obtaining financing), recapitalisations and sales to other private equity funds or to financial institutions. As in many other jurisdictions, the popularity of listing as an exit strategy has fluctuated in South Africa in recent times but continues to be a viable option, although listing on a foreign stock exchange is complicated by exchange control regulations.

14 Limitations on transaction size

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

There is no general limitation in place over the size of transactions private equity firms may be engaged in. The size of the transaction may, however, necessitate certain regulatory approvals and disclosures.

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?

As indicated above, exit strategies commonly encountered in South Africa include trade sales, listings on the JSE, management buyouts and sales to other private equity companies, and they are painstakingly negotiated in practice. There is, however, no clearly identifiable practice or standard in this regard.

Similar to other jurisdictions, returns from private equity investment in South Africa are usually realised by means of a sale or merger, an initial public offering (these are relatively rare) or recapitalisation. There has been a trend in South Africa for private equity firms to require their investment to be recouped within a period of five years in leveraged buyout transactions. Private equity investments are often

Update and trends

South African private equity funds are increasingly exploring investment opportunities into the rest of Africa, and in particular sub-Saharan Africa. It is expected that infrastructure, manufacturing, retail, real estate, banking and telecommunications will lead the way into what is known as 'Frontier Africa' – the region from South Africa in the south to Senegal in the west and Kenya in the east. Africa has become attractive to South African private equity funds due to its abundant natural resources, low asset valuations, commitment to economic reforms, a gradually improving legal framework for investors and companies, decline in political conflict and wars and its apparent robustness against the world financial crisis and economic recession. To this end, further relaxations of exchange control regulations that apply to private equity funds that are South African residents have been introduced. This new exchange control dispensation will allow private equity funds to make investments into the rest of Africa, subject to the conditions referred to in question 18, and raise capital offshore without exchange control approval. These changes will be effective from 1 January 2011 and in this regard, we understand that the SARB will publish further details on these reforms during the early part of 2011.

plagued by poor liquidity due to the lack of a ready market for such investments, and difficulties sometimes arise in matching the expectations of buyers and sellers, factors that have contributed to the low level of interest in start-up capital. During 2010, the global economic climate was marked by a low degree of competition for assets with private equity firms preferring to extend investment horizons and avoid or delay exit strategies until higher values for their investments could be achieved. As the global economy begins to show signs of recovery, private equity firms are expected to be more willing but still cautious to make new or exit existing investments. There is likely to be a trend in South Africa for private equity firms to exit investments to trade players and other private equity firms instead of through management buyouts and management buy-ins, particularly where debt becomes an available source of funding to such firms.

Owing to the factors mentioned above, among others, providers of debt finance often require the back-ranking of the claims of the private equity entity against the target company. Personal suretyships are frequently required, and in certain cases investments must be approved in advance by the providers of debt finance.

16 Principal accounting considerations

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

Accounting considerations generally mirror those of other classes of transactions. In particular, the treatment of goodwill is considered important as it is not allowed as a tax deduction. The intangible assets of the target are accordingly carefully scrutinised.

With effect from reporting periods subsequent to 30 June 2005, SAVCA has formally adopted the International Private Equity and Venture Capital Valuation Guidelines published by the Association Française des Investisseurs en Capital, the British Venture Capital Association and the European Private Equity and Venture Capital Association.

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

Despite a marginal increase in early-stage investments in 2006, the South African private equity market leans towards later-stage investments, and investments in seed, start-up and early-stage entities remain at low levels. This has been a consistent trend across all sectors with private equity firms showing a tendency to replace or expand existing capital reserves. In 2010, the majority of private equity activity took place in the mining and natural resources sectors with greater interest being shown in the infrastructure, information technology, services and manufacturing sectors. To the extent that BEE transactions are private equity transactions, BEE transactions have been prevalent over all economic sectors in recent years due to the fact that BEE is a legislative imperative that applies to all the sectors of the South African economy.

The trend in South Africa for private equity investment has not been towards any specific sector, the focus being on the assets and cash flows of the target. A recent development is the establishment of private equity funds focused on business rescue transactions. Business rescue mechanisms may feature in relation to private equity transactions in South Africa during 2011, as the new Companies Act (which is currently expected to come into force during the second quarter of 2011) makes specific provision for restructuring of companies that are insolvent or may imminently become insolvent. However, business rescue funds can be expected to be more sensitive than other funds due to the lack of credit in the markets.

Although industry-specific regulatory schemes do not limit acquisitions by private equity firms, private equity acquisitions are subject to the general restrictions and requirements imposed by such industry-specific regulatory schemes. A few examples of these are set out below.

The Banks Act, 1990 provides that the acquisition of shares in a bank or the controlling company of a bank, if resulting in the acquirer holding more than 15 per cent of the issued shares in the bank or controlling company, is subject to the consent of the registrar of banks. A similar restriction applies in respect of the acquisition of more than 24 per cent of the issued shares in a bank or controlling company of a bank. An acquisition resulting in the acquirer holding more than 49 per cent and 74 per cent, respectively, requires the approval of the minister of finance.

The Short-Term Insurance Act, 1998 and the Long-Term Insurance Act, 1998 prohibit the acquisition of shares or any other interest in an insurance company that will result in the acquirer (whether alone or with a related party) controlling the insurance company save with the approval of the relevant registrar (being either the registrar of short-term insurance or the registrar of long-term insurance). For these purposes, a person is deemed to 'control' a company if he or she: holds 25 per cent or more of the issued shares of the company; holds shares that entitle him or her to exercise 25 per cent or more of the voting rights in the company; or can determine the appointment of 25 per cent or more of the directors of the company. The two insurance acts provide specifically that the acquisition of shares in an insurance company is subject to the approval of the relevant registrar if it results in the acquirer (whether alone or together with a related party) holding 25 per cent or more of the issued shares of the relevant company.

Acquisition of control of entities that administer the assets of pension funds is also subject to regulatory approval.

18 Cross-border transactions

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

Foreign investment in and disinvestment from South Africa is subject to strict exchange control regulations, particularly those transactions entailing outflows of capital. The Exchange Control Regulations

1961 (the Regulations) govern the movement of capital, be it direct or indirect, across the borders of South Africa. The Regulations require that such movements of capital be approved by the South African Reserve Bank (the SARB) subject to certain concessions in respect of member countries of the Southern African Development Community. The SARB has granted the authority to certain authorised dealers to authorise transactions in certain specified circumstances that would otherwise have required SARB approval.

Foreign funders of private equity funds in South Africa should bear in mind that the repatriation of both capital and profit will require exchange control approval. This is generally dealt with in advance in the context of the initial investment arrangements. Outward investment by South African private equity funds is also subject to exchange control approval. The SARB, however, has announced that, with effect from 1 January 2011, private equity funds that are South African residents and that are members of SAVCA will be allowed to make investments into the rest of Africa and raise capital offshore without exchange control approval provided that they apply to the SARB for an annual approval to invest into Africa and provide, inter alia, confirmation that they will retain a minimum of 10 per cent of the voting rights in the respective investments into Africa. We understand that the SARB will publish further details on these reforms during the early part of 2011. South African institutional investors, such as managers of collective investment schemes, are entitled to a foreign investment allowance (with certain additional concessions in respect of outward investment into Africa). South African individuals with the appropriate tax clearance are permitted to make outward investments subject to certain thresholds. South African companies, however, must obtain the specific approval of the SARB in respect of outward investments. It is envisaged that the Regulations will be relaxed in the future, various concessions having been introduced over the years.

Cross-border transactions in South Africa normally include complex hedging arrangements to minimise currency risk. Managing exchange rate risks is important for non-resident private equity entities in the current volatile global environment.

19 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?

Club or group deals are relatively rare in South Africa (despite the presence of certain private equity firms that focus on putting together such deals). Club or group deals are usually structured as limited liability partnerships and sometimes involve tiers of limited liability partnerships or other funding structures – as is often the case in deals having an offshore funding component. Care must be taken in structuring complex funding structures to ensure that the regulatory frameworks relating to financial services, collective investment schemes and banks are not inadvertently brought into operation. The equity, debt and insurance wrappers used by the hedge fund industry can be regarded as a form of group deal, although in practice there is often no wish on the part of individual investors to regard themselves as part of a group of investors.

Club or group deals in South Africa often involve a lead investor who takes investment decisions or an independent investment manager or both. The presence of an independent investment manager (who would usually be a regulated entity) is often favoured by offshore funders as it gives them an added layer of protection in an unfamiliar jurisdiction.

The formulation of a comprehensive investment mandate has proven important in club or group deals.

20 Issues related to certainty of closing

What are the key issues that arise between a seller and a private equity buyer related to certainty of closing? How are these issues typically resolved?

On the one hand, the seller insists on certainty that a buyer cannot terminate the transaction agreement in the absence of a material adverse change in the seller's business and, in this regard, requires effective remedies against a buyer for wrongful termination. Specifically, the seller will seek to maintain its right to seek specific performance of the transaction, that is, the right to require the buyer to close the transaction.

On the other hand, the private equity buyer would insist on certainty in regard to both the circumstances in which it can terminate the transaction agreement if the assumptions on which it agreed to buy the seller's business have materially changed and the maximum amount of potential recourse that a seller has against it if it terminates. In this regard, the buyer typically insists on the right to terminate the transaction for any reason upon payment of an agreed termination fee. This limits the buyer's exposure and the sellers' remedies in the event that the buyer does not close the transaction for any reason, including failure to obtain financing.

In small private equity transactions where regulatory and other approvals or consents are not required, both parties normally insist on signing and closing to occur simultaneously in order to ensure certainty of closing.

* *The authors wish to acknowledge Mogola Makola's contribution to this chapter.*

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 ISSN 1746-5524