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Private Equity 2021

Puerto Rico
Miguel Otero Sobrino and Alexis González-Pagani
Ferraiuoli LLC

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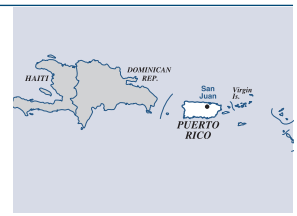
PUERTO RICO

Law and Practice

Contributed by:
Miguel Otero Sobrino and Alexis González-Pagani
Ferraiuoli LLC see p.12



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1. TRANSACTION ACTIVITY

1.1 M&A Transactions and Deals

There is currently a very active sellers' market in Puerto Rico, with buyers eager to put their capital to work in various sectors and industries. Volumes have accelerated for many reasons, including substantial demand among mid-sized developed businesses looking to expand into new markets, the limited supply of local banks, and resilient valuations, even in the midst of a global pandemic.

There has been an increase in private equity firms and venture capital funds carrying out fast-tracked acquisitions and exits, either accelerating long-term strategies to gain market and growth or in response to hardship.

1.2 Market Activity

The commercial real estate, entertainment, auto, food and food technology, technology, hospitality and lodging sectors have shown significant activity and continued acceleration during 2020 and 2021.

2. PRIVATE EQUITY DEVELOPMENTS

2.1 Impact on Funds and Transactions

On 1 July 2019, the Governor of Puerto Rico signed Act No 60 into law, known as the Puerto Rico Incentives Code, as amended (the Incentives Code), repealing Act 185 of 2014, known as the Puerto Rico Private Equity Funds Act (Act 185). Although the Incentives Code generally incorporates the provisions of Act 185, certain benefits changed while other provisions were clarified. As a result, the Incentives Code now establishes the framework for the following:

- requesting treatment as a either Puerto Rico private equity fund (PR-PEF) or private equity funds;
- eligibility requirements; and
- the taxation of funds, among other aspects.

Attractive characteristics of the Incentives Code include that investors that invest in a private equity fund are entitled to take a deduction up to a maximum of 30% of their initial investment within a maximum period of ten years, provided that the maximum deduction does not exceed 15% of the investor's net income prior to such deduction. Also, investors that invest in a PR-PEF are eligible to deduct up to a maximum of 60% of their initial investment within a maximum period of 15 years, provided that the maximum deduction does not exceed 30% of their net income prior to such deduction.

The general rule is that an investor's share of income derived by a qualifying fund from interest and dividends is subject to an income tax of 10%. However, the distributive share of investors that are registered (or exempt) investment advisers, private equity firms or general partners in interest and dividends derived by a qualifying fund will be subject to income tax at the rate of 5%.

In addition, an investor's distributive share of capital gains realised by the qualifying fund is exempt from Puerto Rico income tax. The general rule is that capital gains realised by an investor upon the sale of shares in a qualifying fund are subject to income tax at a rate of 5%. However, if the investor is a registered (or exempt) investment adviser of the qualifying fund, a general partner of the qualifying fund or a private equity firm, then the gain will be subject to income tax at a rate of 2.5%. As an exception, capital gains realised by investors upon the sale of shares in a qualifying fund will not be subject to the 5% or 2.5% tax (as the case may be) if the gross

proceeds from the sale are reinvested in a PR-PEF within 90 days of the sale, in which case the capital gains will not be subject to income tax.

In addition to the benefits offered by the Incentives Code to funds and investors, under a separate section certain investment advisers who are organised in Puerto Rico or establish operations in Puerto Rico that provide advice to funds located outside of Puerto Rico or to other investment advisers located outside of Puerto Rico (ie, export their services) are electing to be taxed as corporations to benefit from the interplay of Section 933 of the United States Internal Revenue Code of 1986, as amended (IRC), and the Incentives Code, which provides a preferential tax rate of 4% for services rendered from Puerto Rico to persons located outside of Puerto Rico, such as funds, other investment advisers or investors.

In addition, the Incentives Code provides a 0% rate on dividends distributed by the entity to its owners that are residents of Puerto Rico from income derived from export activities. Please note that the Incentives Code requires grantees to have at least one full-time employee within the 18 months after the commencement of operations.

The terms of the exemption provided to the entity under the Incentives Code are gathered in a Tax Grant, which is considered a contract between the government of Puerto Rico and the entity that requested the benefits. The initial term of a Tax Grant under the Incentives Code is 15 years, which can be extended for an additional 15 years.

Furthermore, under a separate section of the Incentives Code, an exemption from Puerto Rico-sourced passive income (including interest and dividends that flow through the fund) can be obtained by individuals that relocate to Puerto Rico. This includes capital gains, interest and dividends. The provisions of the Incentives Code that provide these benefits tie into both the IRC exemption for a bona fide resident to not be subject to federal taxation on Puerto Rico-sourced income and the sourcing rules of the IRC. Therefore, for example, an individual who receives interest income from an investment in a fund located in Puerto Rico would be exempt from Puerto Rico and federal taxes. By the same token, given that capital gains are sourced to the residence of the seller and, in the case of partnership, are determined at the level of the partners, investors can greatly benefit from the interplay of the above rules.

Lastly, an individual who owns an investment adviser that has a Tax Grant (as discussed above) and provides services to an Alternative Investment Fund or to another investment adviser located outside of Puerto Rico can receive dividend distributions subject to a 0% tax rate.

3. REGULATORY FRAMEWORK

3.1 Primary Regulators and Regulatory Issues

Private equity funds, venture capital funds and their investment advisers organised under the laws of Puerto Rico and/or doing business in Puerto Rico are subject to the laws of the United States and all applicable rules and regulations promulgated by the Securities and Exchange Commission (the SEC) and the local regulator in Puerto Rico, the Office of the Commissioner of Financial Institutions of Puerto Rico (OCFI).

Usually, private equity-backed buyers need to comply with the provisions set forth in Act No 77 of 1964, as amended, known as the Puerto Rico Anti-Monopolistic Act (Act 77-1964). Act 77-1964 regulates unlawful mergers and business practices, generally to promote fair com-

petition for the benefit of consumers in an open market economy. Specifically, Act 77-1964 states that it is unlawful to sell, contract to sell, offer to sell, or participate in any step for the sale with the purpose of destroying competition or eliminating a competitor located in Puerto Rico.

The Puerto Rico Department of Justice Office of Monopolistic Affairs (OMA) is authorised to investigate and initiate legal action to protect free competition practices in accordance with the Puerto Rico Antitrust Act, which was enacted to regulate any unlawful restraints of trade or commerce and exempts the legal regulation of public utilities, insurance companies and any other enterprises or entities subject to special regulation by the governments of Puerto Rico or the United States. As per the Puerto Rico Antitrust Act, similar to the federal antitrust laws, a contract, combination in the form of trust or otherwise, or conspiracy that "unreasonably restrains trade or commerce in Puerto Rico" is illegal. With regards to M&A, the Puerto Rico Antitrust Act states that it shall be unlawful if the effect of such acquisition may be to "substantially lessen competition, or to tend to create a monopoly". These antitrust regulations will generally apply to business combinations and private equity-backed buyers.

In addition, if the private equity firm or venture capital fund enjoys a preferential tax treatment under the Incentives Code or Act 185, it will be subject to the oversight of the Office of Incentives for Businesses in Puerto Rico (OI) and the Puerto Rico Treasury Department. Furthermore, depending on whether or not it relies on an exception from registration under SEC Rule 203-1(l) or 203-1(m), there are different types of limitations on the type of portfolio company acquisitions that the entity can undertake and/or the amount of leverage it can assume.

4. DUE DILIGENCE

4.1 General Information

The level of legal due diligence varies, but there is certain information that is generally requested, mostly consisting of confirmatory verifications and validations. This means that, at this stage, the buyer should be very much assured of their decision to move forward absent any new material findings.

The key area of focus for legal due diligence in private equity transactions is to corroborate assumptions made by the buyer in arriving at a certain valuation, and to substantiate that the company is not exposed to large unidentified liabilities or contingencies, and to thoroughly evaluate the company's structure and compliance with applicable laws and regulatory frameworks. A due diligence exercise typically covers the following:

- general corporate information;
- governmental and regulatory documents;
- financial documents;
- litigation documents;
- material contracts;
- real estate and assets;
- environmental matters;
- employee compensation and benefit documents;
- intellectual property;
- tax matters; and
- insurance.

4.2 Vendor Due Diligence

Vendor due diligence is not a common feature of private equity transactions in Puerto Rico.

5. STRUCTURE OF TRANSACTIONS

5.1 Structure of the Acquisition

Most acquisitions by private equity funds are typically carried out by private stock or membership interest purchase agreements. Other acquisitions by private equity funds are performed by acquiring the debt of the target company, by issuing new debt to the target company and/or by entering into debt that converts to ownership of the target company (eg, convertible promissory notes).

5.2 Structure of the Buyer

As a general rule, funds that will target both their investments and investor base in Puerto Rico are organised as limited liability companies (LLCs). LLCs organised in Puerto Rico are taxed as corporations by default. However, the Puerto Rico Internal Revenue Code of 2011, as amended (the PR IRC), allows LLCs to elect to be treated as partnerships for income tax purposes, even if the LLC has only one member. The PR IRC currently does not provide for entities to be taxed as disregarded entities. As with tax elections made pursuant to the IRC, the election to be taxed as a partnership under the PR IRC allows funds to be transparent for Puerto Rico tax purposes, making the members the parties responsible for the tax liability instead of the fund. Furthermore, the PR IRC provides that every LLC that is treated as a partnership by reason of its election or provision of law or regulation under the IRC, or the similar provision of a foreign country, or whose income and expenses are attributed to its members for federal income tax purposes or those of the foreign country, shall be treated as a partnership for purposes of the PR IRC, and shall not be eligible to be taxed as a corporation.

The private equity-backed buyer is typically structured as a "qualifying private fund" exempt from registration under SEC Rule 203(m)-1. The term "qualifying private fund" refers to any private fund that is not registered under Section 8 of Federal Investment Company Act of 1940, as amended (the ICA), and has not elected to be treated as a business development company pursuant to Section 54 of the ICA.

It is common for the general partners to manage the acquisition (or sale) documentation. As the general partners oversee the day-to-day operations of the firm and manage the portfolio companies, they will lead the acquisition (or sale). Depending on the complexity of the transaction, on some occasions the general partners engage the investment adviser of the fund or a third-party subject matter expert adviser for additional support during the due diligence process.

5.3 Funding Structure of Private Equity Transactions

Generally, private equity deals are financed through capital contributions in the fund. Typically, the fund provides investors with an approximate target for the fund size and the minimum amount of investment that must be committed by the investors prior to becoming partners in the fund (ie, the Capital Commitment). Once the fund determines the investment it wishes to pursue, the general partner or investment adviser will notify the partners of the amount of capital that they must provide the fund (ie, Capital Call) and the timeframe in which they must provide them. The Capital Call in no case can exceed the initial Capital Commitment made by the partners, unless the partners and the fund reach an agreement to the fact. Once the fund has sufficient funds, it deploys them in pursuit of the investment. Most private equity deals are geared towards the fund obtaining a majority ownership interest in the investment.

5.4 Multiple Investors

Deals involving a consortium of private equity sponsors are not common in Puerto Rico, but

co-investment by other investors alongside the private equity fund is very common. Of late, the majority of private equity fund sponsors are requesting the ability to offer co-investments as an attractive element of their structures, during the organisation stage of the fund. For example, co-investments tend to provide private equity firms with more flexibility on the terms and conditions of a particular transaction. Private equity firms can have more capital available to invest in other projects rather than in a single transaction. Co-investments may also improve relationships with investors and the distribution of the investment risk.

For co-investors, the co-investment transaction may allow exposure to additional information and access to due diligence or materials that would not otherwise have been available solely to the private equity fund. Co-investments can also help the co-investor make better decisions and adjust their broader portfolio to best fit their investment needs.

Another advantage is that an institutional investor may receive better fee arrangements in the co-investment special purpose vehicle compared to investing in the main private equity fund. For example, a private equity firm that may wish to attract institutional investors could reduce fees.

Lastly, co-investors are typically limited partners or their affiliates alongside the general partner by way of passive stakes by the co-investors and where the fund and its limited partners are already investors. In some limited occasions, external co-investors operate alongside the general partner of the fund by way of passive stakes.

6. TERMS OF ACQUISITION DOCUMENTATION

6.1 Types of Consideration Mechanisms

The predominant form of consideration used in private equity transactions in Puerto Rico is cash. Earn-outs and deferred consideration are not common features of private equity transactions in Puerto Rico. However, some private equity funds opt to implement a milestone approach investment where a second larger investment is made in a company once it has achieved certain performance metrics.

The involvement of a private equity fund may affect the type of consideration mechanism used, depending on whether the fund has elected to operate with a Tax Incentives Grant under the Incentives Code and whether the partners in the fund hold individual Tax Incentives Grants also issued under the Incentives Code. If the fund and the partners do hold Tax Exemption Grants, the fund will mainly target income streams covered under the corresponding Tax Exemption Grants.

A private equity buyer does not usually require enhanced or additional protections when making an investment. In contrast, corporate buyers may request collateral and other types of security instrument to protect their investment.

6.2 Locked-Box Consideration Structures

The vast majority of private equity transactions are based on locked-box considerations, but no interest is charged on leakage.

6.3 Dispute Resolution for Consideration Structures

Generally, dispute resolution mechanisms are in place for all types of private equity transactions.

6.4 Conditionality in Acquisition Documentation

The typical conditions to closing are as follows:

- regulatory approvals, as may be required;
- the approval of certain contractual counterparties;
- the conversion of convertible instruments; and
- corporate resolutions approving the transaction.

Material adverse effects provisions are very common in private equity transactions, particularly when the transaction is not designed as a simultaneous sign and close.

Third-party consents are generally requested for closing a private equity deal, when material contracts are involved that require consent for assignment or when a change of control occurs. This is more common in certain industries, such as distribution, services, etc.

6.5 "Hell or High Water" Undertakings

Hell or high water provisions are not usually accepted by a private equity-backed buyer, with such burden usually being placed on the seller's side.

6.6 Break Fees

Break fees are not common in Puerto Rico but may be agreed to in certain scenarios involving publicly traded buyers.

6.7 Termination Rights in Acquisition Documentation

A private equity seller or buyer can usually terminate an acquisition agreement in the following circumstances:

- when the deal has not closed by a certain drop dead date;
- when third-party or required governmental consents are not granted or obtained; or
- for reasons stemming from the due diligence.

6.8 Allocation of Risk

Transactions where the seller is a private equity fund and the buyer is another private equity fund are not common in Puerto Rico at this time but the market is likely to develop and require those types of transactions.

6.9 Warranty Protection

A private equity seller normally provides typical title, no liens and authority warranties to a buyer upon an exit. The management team provides business representations to a buyer on exit. It is customary for a cap to be placed on liability for business warranties, but fundamental warranties are either uncapped or capped at the purchase price. Full disclosure of the data room is typically not allowed against the warranties. Typical limitations on liability for warranties in Puerto Rico include basket, caps and sunsets.

6.10 Other Protections in Acquisition Documentation

Indemnities are generally the only protection provided to private equity buyers and sellers. Insurances are not common, and escrows are only considered when a corporate buyer is involved.

6.11 Commonly Litigated Provisions

Litigation is not common in connection with private equity transactions in Puerto Rico.

7. TAKEOVERS

7.1 Public-to-Private

Public-to-private private equity transactions are not common in Puerto Rico.

7.2 Material Shareholding Thresholds

Under the PR IRC, partnerships (including funds) must file an Informative Income Tax Return for Pass-Through Entity, and their income flows through and is taxed to the partners. The partnership must also make estimated tax payments equal to 30% of any taxable income that is subject to tax at regular rates, plus the preferential tax rate applicable to any taxable income that is subject to a preferential tax rate under the PR IRC. The estimated tax payments may be claimed by the partners as a credit on their annual Puerto Rico Income Tax Return. Accordingly, the estimated tax payments are not an additional tax, but merely a prepayment of the partner's income taxes.

The fund must also provide each of its partners with an informative return detailing all of the information required by the partner for the purposes of completing their income tax return.

The fund income tax return must include audited financial statements, including certain supplementary information established by law, prepared by a Certified Public Accountant who is licensed to practise in Puerto Rico. This requirement only applies to funds with a gross income exceeding specific thresholds provided in the PR IRC.

Furthermore, funds that operate with a Tax Incentives Grant must provide audited annual reports to their partners, including audited financial statements prepared under the Generally Accepted Accounting Principles (GAAP), as well as an unaudited report on the performance of individual portfolio companies. Quarterly unaudited financial statements must also be provided to partners.

7.3 Mandatory Offer Thresholds

Puerto Rico does not have a mandatory offer threshold.

7.4 Consideration

Both cash and share considerations are widely used in Puerto.

7.5 Conditions in Takeovers

Takeovers are not common in Puerto Rico.

7.6 Acquiring Less than 100%

Squeeze-out mechanisms are not common in Puerto Rico.

7.7 Irrevocable Commitments

It is not common to obtain irrevocable commitments to tender or vote from the principal shareholders of a target company.

7.8 Hostile Takeover Offers

Hostile takeover offers are permitted in Puerto Rico, but are rare at a private equity fund level.

8. MANAGEMENT INCENTIVES

8.1 Equity Incentivisation and Ownership

Equity incentivisation of the key management team is a common feature of private equity transactions in Puerto Rico. The key management team is usually provided equity depending on their expertise and their role in the company and industry sector.

8.2 Management Participation

Management participation is typically structured as sweet equity subject to vesting. Managers will usually subscribe for ordinary equity or a tracking phantom equity that will follow the performance of a particular metric. Also, a cliff and/or vesting schedule will be included in the management equity (see **8.3 Vesting/Leaver Provisions**).

8.3 Vesting/Leaver Provisions

Leaver provisions for key management shareholders are typically included in Puerto Rico to attract and retain top talent in many private equity funds, especially in the tech sector. The typical leaver provisions for management shareholders are:

- death;
- permanent disability or permanent incapacity through ill health;
- permanent disability or permanent incapacity through ill health of the executive's spouse or child;
- retirement (at normal retirement age);
- redundancy;
- unjustifiable dismissal by the company; and
- on some occasions, dismissal by the company where the executive has failed to meet certain performance expectations.

A typical vesting clause will usually last four years and have a one-year cliff.

8.4 Restrictions on Manager Shareholders

One of the most used restrictive covenants agreed to by management shareholders is a non-compete agreement. In Puerto Rico, the courts often disfavour non-compete clauses, as Article II sec. 16 of the Constitution of Puerto Rico recognises the right of every worker to choose his/her occupation and freely resign. To protect this liberty of choice, Puerto Rico courts have carefully interpreted non-compete clauses and imposed rigorous requirements for their validity. When these are not met, the contract will most likely be deemed invalid and unenforceable.

Valid non-compete clauses require the employer to have a legitimate interest in the contract – ie, the business would be substantially affected if the employer does not receive protection under a non-compete agreement. The scale of this interest is measured, considering the position of the manager within the company – the existence of the manager's interest will be directly related and reliant on the manager's position in the company, and whether they compete with the company in the future.

The extent of the prohibition must correspond to the interest of the company, regarding restriction terms or affected customers. The purpose of the ban should be limited to activities like those conducted by the employer and does not have to be limited to specific functions. Also, the term of the non-compete agreement should not exceed 12 months, understanding that any additional time is excessive and unnecessary to adequately protect the employer.

In terms of the reach of the prohibition, the contract must specify the geographic boundaries and/or affected customers. The geographical area to which the restriction applies should be limited to the area strictly necessary to prevent real competition between the employer and employee. When the non-competition clause concerns customers, it should refer only to those who personally attended the employee for a reasonable period before leaving or in a period immediately preceding the exit of the manager. These elements are evaluated in light of the nature of the industry involved and the possible related public interest.

Additionally, the company must offer something to the manager in return for signing the non-compete agreement, such as a promotion, additional benefits at work or the enjoyment of any similar substantial changes in employment conditions, including a manager keeping a position after a change in ownership of the company when another consideration also applies.

As with any contract, non-compete agreements must have the essential elements for validity:

consent, object and cause. However, it is a strict requirement that the managers freely and voluntarily sign the non-compete agreement: undue pressure or coercion by the company would render the non-compete agreement invalid and unenforceable.

In summary, the elements of a valid non-competition agreement in Puerto Rico are as follows:

- the company must have a legitimate interest in the agreement;
- the scope of the prohibition in the non-compete agreement must fit the company's interest but not exceed 12 months;
- the company shall offer a consideration in exchange for the employee signing the non-competition covenant, other than mere job tenure;
- non-competition agreements must be valid contracts; and
- non-competition covenants must be in writing.

8.5 Minority Protection for Manager Shareholders

Management typically does not have rights under minority protection provisions.

9. PORTFOLIO COMPANY OVERSIGHT

9.1 Shareholder Control

The most common control mechanisms awarded to certain limited partners in the private equity fund on specific portfolio investments are board appointment rights and information rights. However, most of the board appointment rights and information rights are granted at the private equity fund level and not at the portfolio investment level.

9.2 Shareholder Liability

It would be extremely difficult for a private equity fund majority shareholder to be held liable for the actions of its portfolio company, as two corporate veils would have to be pierced. However, such corporate veils may be pierced by a court of law in an extreme case where both the private equity fund and the portfolio company are part of a scheme to commit fraud.

9.3 Shareholder Compliance Policy

Private equity fund shareholders do not typically impose compliance policies on the portfolio companies.

10. EXITS

10.1 Types of Exit

In Puerto Rico, the typical holding period for private equity transactions is between three and six years. The most common exit route is a trade sale, which allows all management and institutional investors to be entirely cashed out and focused on new ventures. Dual track exits are uncommon in Puerto Rico.

Private equity sellers typically reinvest upon exit, depending on the given term of the private equity fund and any reinvestment restrictions.

10.2 Drag Rights

Drag rights are agreed to in private equity investments. The typical drag threshold for any person(s) selling is that they hold more than 50% ownership.

10.3 Tag Rights

Tag rights are typical in private equity investments. The typical tag threshold for any person is that they hold more than 50% ownership.

10.4 IPO

This is not applicable in Puerto Rico.

Ferraiuoli LLC is one of the leading full-service law firms in San Juan, Puerto Rico, with an experienced and agile team of professionals providing unparalleled and personalised service to clients. The firm provides high-quality comprehensive legal advice and representation to industry-leading private and publicly owned companies, as well as financial institutions, on corporate, tax, intellectual property, labour and other regulatory issues. Ferraiuoli serves clients in Puerto Rico and the US mainland, as well as the Caribbean and Latin America. The attorneys work in teams, as appropriate, with stateside and international advisers and counsels, and are committed to pursuing clients' business goals in a responsive and cost-effective manner. Several of the firm's attorneys hold dual professional licences and are authorised to practise in the State of New York, the State of Florida, the State of Texas and the State of California, in addition to the Commonwealth of Puerto Rico and the US Federal Courts System.

AUTHORS

Miguel Otero Sobrino focuses his practice on the organsation and continuing operation of a variety of private investment funds, including private equity funds, venture capital funds, hedge funds and funds of funds. His experience with private investment funds extends to the development and negotiation of the organisational documents of such funds and the preparation of their offering materials. Miguel also provides legal counsel to banks, financial institutions, international financial entities, investment firms and asset managers in a broad range of regulatory and compliance issues, including matters related to the Federal Deposit Insurance Corporation and Consumer Financial Protection Bureau as well as other relevant regulators, such as the Securities and Exchange Commission and the Office of the Commissioner of Financial Institutions.

Alexis González-Pagani focuses his practice on addressing the international taxation issues of individuals and entities; assisting the relocation process of individuals and companies to Puerto Rico; the structuring of new businesses in and outside of Puerto Rico; advising on the restructuring of existing businesses in order to maximise tax savings and opportunities; structuring the inbound Puerto Rico investments and operations of multinational entities; working on the tax aspects of contracts, mergers, acquisitions and reorganisations in Puerto Rico; and advising on the structuring and organisation of private equity funds, venture capital funds and hedge funds that operate and invest in and outside of Puerto Rico.

Ferraiuoli LLC

221 Ponce de León Avenue
Suite 500
San Juan
PR 00917
PUERTO RICO

Tel: +787 766 7000
Fax: +787 766 7001
Email: info@ferraiuoli.com
Web: www.ferraiuoli.com