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Acquisition Finance

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Introduction

One of the main issues for the purchaser of a company is how to finance the acquisition. Broadly, the purchaser can either borrow money (i.e. debt finance) or issue shares (i.e. equity finance). A number of factors will determine which form of financing will be more appropriate for a given acquisition (including structural and tax issues) but the principal factor is usually the cost of the debt finance versus the cost of equity finance.

Debt finance of this kind is described by a plethora of terms, many of which (somewhat unhelpfully) overlap in their meaning. The two principal types of debt finance transactions are those where a financial sponsor effects the transaction (generally referred to as "leveraged buy-outs"), and those where an existing business effects the transaction (generally referred to as "leveraged corporate acquisition"). However, as this briefing paper will not address the differences between such transactions, we will simply use the term "acquisition finance". Further, this briefing paper focuses only on issues encountered by financiers in debt finance transactions and does not consider similar factors in equity finance transactions.

A lender financing the purchase of a company will have the following as its main objectives:

- To ensure that the acquisition is documented properly, giving the purchaser appropriate protection as a purchaser (and ensuring that such protections are assignable to the lender).
- To ensure that it obtains watertight security.
- To ensure that all other debts owed by the purchaser and the company being acquired (the "**Target**") are fully subordinated to the lender's debt.

Types of Debt

Acquisition finance is usually comprised of senior (sometimes combined with second lien debt – a form of "stretched" senior debt), mezzanine and other junior debt.

Senior Debt

Senior debt is the main form of acquisition finance and will be used in all buy-outs. It will generally comprise (a) a secured term loan to fund the acquisition itself (and related costs), (b) a working capital facility (usually a revolving credit facility), and (c) an ancillary facility (such as an overdraft) for specific purposes.

Depending on the value of the transaction, the senior debt will be provided by a single acquisition finance bank or, for a larger loan, by a "club" of banks or underwritten by one or more banks and then syndicated. Acquisition finance may also be provided by non-bank institutional lenders.

The senior debt will usually be the largest part of the acquisition finance and will rank in priority to all other debt.

Second Lien Debt

Second lien debt is a type of secured debt which will usually rank immediately behind the first ranking senior debt and ahead of mezzanine and other junior debt. It often forms a thin layer of debt between the core senior debt and the junior debt packages. Second lien finance has much in common with senior debt (and is often documented together with the senior debt) but it is more risky in terms of enforcement rights against the borrower than senior debt.

Mezzanine Debt

Mezzanine debt sits between senior (and second lien) debt and other junior debt. It is often secured and may also be "warranted" (i.e. giving the purchaser the right to subscribe for shares at a stipulated price). This type of debt is usually repaid by a bullet repayment and tends to be more expensive than senior debt due to deeper subordination and therefore weaker enforcement rights against the borrower.

Other Junior Debt

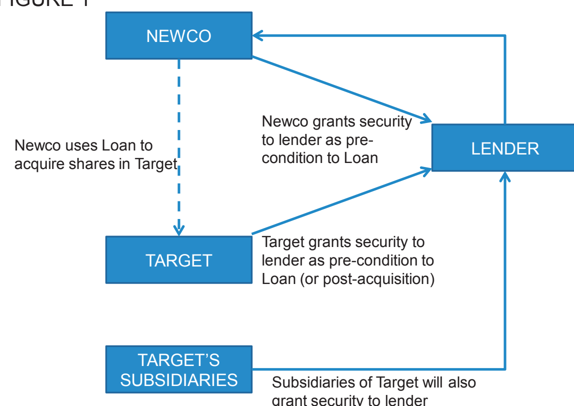
This is any sort of debt which is not senior, second lien or mezzanine debt and is subordinated to the senior debt. Types of junior debt may include the following:

- **High yield debt:** This takes the form of an issue of bonds or "notes" that is issued into the debt capital markets as a source of junior debt (and is often referred to as "junk bonds" due to the sub-investment grade ratings such bonds receive).
- **PIK note debt:** The acronym stands for "payment in kind" and refers to a method of paying interest whereby the borrower pays no cash interest until the principal amount is repaid (thereby allowing for additional debt to be taken on without the additional cashflow implications). PIK debt is the most deeply subordinated type of debt in the acquisition structure and is not repaid until all other debt has been repaid.

Transaction Structure

As soon as the initial due diligence is completed and a commercial deal has been agreed between the purchaser and the seller of the Target, the parties will work together to agree the structure of the transaction.

In a leveraged corporate acquisition the Target is acquired from the seller(s) by an existing corporate business which will often be a company operating in the same business area as the Target. In a typical acquisition finance deal, special purpose vehicles ("**SPVs**") will be established to act as funding and acquisition vehicles. Some funding structures will require the establishment of at least two and often several further SPVs. However, in a simple structure, one SPV ("**Newco**") (which is usually established in the same jurisdiction as the Target) will act as the acquisition and the finance vehicle. A simple acquisition finance transaction is illustrated in *Figure 1* below:



Acquisition Finance

Role of Advisers

Where acquisition finance is provided, the legal advisers acting for the finance parties have a dual role:

- to ensure that the acquisition documentation provides for appropriate protections for Newco, as the purchaser of the Target, in the form of warranties, indemnities and restrictive covenants and that such protections are fully and unconditionally assignable to and by the lender; and
- to prepare the financing documentation, including the security package to ensure that the lender obtains a comprehensive security package which (a) (in the case of a guarantee and supporting security from the Target) is not unlawful financial assistance and is not liable to be set aside on insolvency and (b) takes priority over all other existing and future debt of the Target group.

Acquisition Documentation

The terms on which Newco will acquire the Target will be documented in either a share or in an asset purchase agreement depending on whether it is the shares or the assets of the Target that are the subject of the acquisition.

Due Diligence

The acquisition process will normally start with a careful investigation of the records of the Target to support its valuation and also to establish whether there are any matters which may give rise to concerns from a commercial, financial or legal perspective.

Subject to certain investigations into the financial condition and the legal status of the Target group, it is unusual in the acquisition finance context for the lender or its advisers to carry out any extensive due diligence into the factual position of the Target. Instead, the lender will conventionally seek to rely on the due diligence carried out by financial and legal advisers acting for Newco. It is therefore crucial that the lender is allowed access to and reliance on the reports prepared by Newco's advisers documenting the findings of the due diligence exercise.

Warranties & Indemnities

The findings of the due diligence exercise will be decisive in determining the scope of warranties and indemnities to be included in the acquisition agreement. Warranties are statements which the seller(s) are required to make about the condition and the circumstances of the Target (including its tax position) or the business (as the case may be). A warranty which proves to be untrue or inaccurate may give rise to a claim for damages and therefore the seller(s) will normally seek to make disclosures against the warranties in the form of a disclosure letter. Damages for breach of warranty are assessed according to the loss suffered by reference to the impact on the value of the Target (i.e. the shares being acquired in the Target) or business acquired, and may be restricted if the loss is viewed as too remote or if it has not been mitigated. As a consequence, significant liabilities which are likely to crystallise will usually be subject to a specific indemnity which is not affected by any disclosures in the disclosure letter. Under an indemnity, payment is due on the occurrence of an event covered by the indemnity which compensates for the direct loss or liability incurred by the Purchaser irrespective of the impact on value of the underlying shares of the Target in the case of a share purchase.

The lender will want to ensure that the scope of the contractual protections is appropriate in the context of the particular acquisition and also that the benefit of any such protections is assignable to the lender so that the proceeds from claims against the seller(s) can, if necessary, be used to prepay the facilities. In addition, if the position as warranted proves to be untrue or inaccurate whilst the facilities are outstanding, the lender may be able either to refuse to extend further financing or to demand immediate repayment.

Sometimes a lender requires a warranty and indemnity insurance cover to be obtained by Newco, with the lender being added to the insurance policy as a loss payee. Proceeds from claims under the insurance policies will constitute an additional source of cash to prepay the facilities.

Consideration

The acquisition price may be payable in full at completion or, more commonly, a part of it will be deferred and payable at a future date. Deferred consideration may take a number of forms, including retention (part of the purchase price deposited in a designated account as security for potential breaches of warranties/indemnities), completion accounts (the final amount of the consideration determined post-completion on the basis of, for example, a net assets statement or a valuation of a specific asset) and earn-outs (part of the purchase price calculated by reference to the future performance of the business).

Completion accounts may not necessarily comprise a full balance sheet. A common pricing mechanism is to adjust only for cash and financial debt and possibly also working capital in each case as at completion. Headline prices in term sheets may refer to a specified price on a "cash free debt free basis" assuming a target "normalised" working capital. Translated into the share purchase agreement, a provisional price is paid on completion and then completion accounts drawn up shortly afterwards will drive a price adjustment to the extent there is any net cash or net debt, or if the working capital on completion is below or above the agreed target.

Financing Documentation

Senior Facility Agreement

As Newco is likely to be a shell company whose only assets will be Target's shares and the only potential income stream will be dividend on those shares, the senior facility agreement is likely to contain more restrictive terms than in a conventional facility agreement. It will usually contain clauses dealing with the following acquisition specific points:

- **Facilities and their purposes:** This will typically be a term loan to cover all or part of the acquisition price and transaction costs, and often also a revolving facility for working capital purposes.
- **Interest:** This usually consists of a floating rate plus a margin and may incorporate a margin ratchet allowing for the margin to vary according to the borrower's financial performance.

- **Optional prepayments:** The borrower will normally be allowed to prepay all or part of the term loan facility, subject to the prepayment exceeding a minimum amount and the payment of a prepayment fee. The order in which prepayments will be applied as between different tranches of the senior debt and as against repayment instalments will be negotiated between the parties. Commonly, the different tranches and the repayment instalments within them will be reduced on a pro rata basis.
- **Repayment**: The term loan element will usually be paid back over a five to nine year period. If there are tranches, the first will usually amortise, with perhaps a year's delay to give the business a chance to get going, and any further tranches being repaid with a bullet repayment. Any advances under a revolving facility will normally be repayable after a short term but may be re-borrowed.
- **Mandatory prepayments:** Part or full prepayment will usually be required upon change of control, sale, listing, disposal of assets or warranty claims against or insurance claims in respect of the seller(s).
- **Covenants**: These mainly seek to ensure that certain financial standards are met and that the borrower provides specified information (in particular, financial statements) to the lender to enable it to monitor the borrower's financial and other performance and to prevent the borrower from taking certain actions which might prejudice its commercial or financial status, including a prohibition on encumbering its assets without the prior consent of the lender.

Mezzanine Facility Agreement

Except for the structure and the commercial terms of the facility, the mezzanine facility agreement will largely follow the terms of the senior facility agreement. The major differences relate to:

- **Financial covenants**: These will usually be set at a lower level than those applicable under the senior facility.
- **Interest:** This will usually be higher than on the senior debt to reflect the greater risk and there will usually be no margin ratchet.
- **Prepayment and Repayment:** Prepayments and repayment are normally allowed only after the senior debt has been fully discharged, with the repayment of the mezzanine facility taking place several months after the payment of the final instalment under the senior facility.
- **Equity interest**: It is not unusual for a mezzanine lender to require Newco to issue a warrant to subscribe for its shares which will normally be exercised on "exit" events such as flotation, change of control or liquidation of the Target business.

Security Package

Lenders will invariably seek to secure the financing of an acquisition by obtaining a security interest in the assets of the Newco. Since the Newco will typically be a shell company with no assets other than the shareholding in the Target, the lenders will also look to the assets of the Target to support the Newco's obligations under a loan.

Lenders can choose from a variety of security interests available under English law. Those commonly utilised in the context of acquisition finance include mortgages, fixed and floating charges and assignments of contractual interests. In addition, security over the Newco's and the Target's assets will often be supported by guarantees from each of them, including from the Newco's investors. This will enable the lenders to pursue each of the guarantors should the value of the security prove to be insufficient to satisfy the debt.

If more than one lender provides financing for an acquisition and the interest of each of the lenders is to be secured then it is usual under English law to have a single entity, commonly referred to as security trustee, to hold security on behalf of all finance parties. This avoids the need to grant the security interest separately to each lender and reduces paperwork on the future replacement of a lender. It will usually be the senior lender who will act as security trustee and will distribute proceeds on enforcement of the security in accordance with contractual ranking arrangements between different types of lenders.

The contractual ranking arrangements between separate levels of debt will usually take the form of an intercreditor agreement which commonly governs both the ranking of security and the subordination of debt, including the relationship between debt providers and equity (or quasi-equity) providers.

When taking security interests (including guarantees) over the assets of the Target and the Target group in connection with the financing of an acquisition of shares in the Target, care must be taken that this does not constitute an unlawful finance assistance as described in more detail below.

Financial Assistance

Subject to certain limited exceptions, an English public company and any of its subsidiaries (whether public or private) are prohibited from providing financial assistance for the purpose of: (i) the acquisition of the shares of that public company, or (ii) for the reduction or discharge of any liability incurred by a person for the purpose of the acquisition. It is also unlawful for an English public company to give financial assistance for the purpose of the acquisition of shares in its private holding company, including the reduction or discharge any liability so incurred.

There is no precise definition of financial assistance under English law or an exhaustive list of instances which would give rise to financial assistance. However, the important point is that the financial assistance prohibition is only relevant in the context of share acquisitions and does not apply in relation to asset acquisitions.
In the context of a typical acquisition finance deal (see *Figure 1*), Newco will typically be a shell company with no assets other than the shares in the Target and the lender will therefore look to the assets of the Target to provide security for Newco's loan. If the Target is a public company, any form of guarantee, indemnity, assignment of rights or any type of security provided by the Target to the lender for the purposes of the acquisition of its shares by Newco would constitute financial assistance and would be prohibited. However, it is usually possible to re-register a public Target as a private company after its shares have been acquired by Newco. Once this is done, any post acquisition financial assistance will no longer be an issue and, following the giving of the financial assistance, the Target can (if required) be re-registered as a public company.

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Other Issues

Although financial assistance has for the most part been abolished in relation to private companies, other issues must not be forgotten when taking upstream guarantees/security from the Target. These include:

- **Corporate benefit**: The board of directors must act in the best interest of the company for the benefit of the members as a whole. For this reason, it is common for a shareholder resolution to be passed blessing the transaction which protects the board and third parties dealing with the board.
- **Transactions at an undervalue***:* The grant of a charge by a company will not usually amount to a transaction at an undervalue on the basis that the charge does not itself deplete the company's assets. However, it is a risk that may arise. A transaction at an undervalue arises where the benefit conferred by the company in giving the guarantee/security is significantly more than the benefit received by the company from giving such guarantees/security. In these circumstances, the transaction may be set aside by court order by a liquidator or administrator of the company if:
  - the company was insolvent or became insolvent as a consequence of entering into the transaction; and
  - the company entered into administration or insolvent liquidation within two years of the transaction being entered into.

It is usual for a Lender to require a declaration of solvency from the directors of Target to obtain comfort, but it will be a question of fact whether the Target is or will become insolvent as a consequence of giving a guarantee/charge.

- **Preference:** An administrator or liquidator of the company may apply to the court for an order to have a transaction set aside if the purpose of the transaction was to prefer one creditor over others in the liquidation or administration of the company and:
  - the company was insolvent or became insolvent as a consequence of entering into the transaction; and
  - the company entered into administration or insolvent liquidation within six months (two years if the person receiving the preference is connected with the company) of the transaction being entered into.

  This shouldn't apply in a normal acquisition finance transaction where pressure on the Target to enter into the security package should negate the possibility of an attack on the ground of preference.

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