



# ICLG

The International Comparative Legal Guide to:

## Lending and Secured Finance 2013

**1st Edition**

A practical cross-border insight into lending and secured finance

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## EDITORIAL

Welcome to the first edition of *The International Comparative Legal Guide to: Lending and Secured Finance 2013*.

This guide provides corporate counsel and international practitioners with a comprehensive worldwide legal analysis of the laws and regulations of lending and secured finance.

It is divided into two main sections:

Six general chapters. These chapters are designed to provide readers with a comprehensive overview of key issues affecting lending and secured finance, particularly from the perspective of a multi-jurisdictional transaction.

Country question and answer chapters. These provide a broad overview of common issues in the laws and regulations of lending and secured finance in 35 jurisdictions.

All chapters are written by leading lending and secured finance lawyers, and industry specialists, and we are extremely grateful for their excellent contributions.

Special thanks are reserved for the contributing editor Thomas Mellor of Bingham McCutchen LLP for his invaluable assistance.

Global Legal Group hopes that you find this guide practical and interesting.

The *International Comparative Legal Guide* series is also available online at [www.iclg.co.uk](http://www.iclg.co.uk)

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# Acquisition Financing in the United States: Outlook Improved

Morrison & Foerster LLP

Geoffrey R. Peck



## Optimism for 2013 Mergers and Acquisitions in the United States

The 2013 outlook for mergers and acquisitions in the United States continues to grow more robust, which should result in more acquisition financings. Participants in acquisition financings should understand the marketplace for M&A activity as the relative volatility or stability of the market often impacts the terms of the financing and whether the terms are more favourable to lenders or borrowers.

Many factors led to cautious levels of 2012 M&A activity. These included steep mandatory tax increases and spending cuts to be imposed at year-end (the so-called “fiscal cliff”), sovereign debt crises in Greece, Portugal, Spain and Ireland and fear of contagion throughout Europe and its impact on the Euro, unstable U.S. and Asian financial markets, the U.S. presidential election, more aggressive U.S. antitrust oversight and continued lack of financial regulatory clarity from Congress. These and other factors resulted in sluggish M&A activity in both large public and middle-market deals.

There are reasons for optimism in 2013. Concerns about some of the 2012 issues have gone away: implementation of a partial, last-minute fix for the fiscal cliff; less fear of spreading sovereign debt crises in Europe; and conclusion of the presidential election. Continued recovery from the 2007 financial crisis and increased collateralised loan activity should result in continued increases in available liquidity. Many corporate balance sheets continue to be flush with cash and many private equity funds have both deep pockets of uncalled capital and the need to sell portfolio companies that, but for the financial crisis and long recovery, would have been sold earlier. In addition, a recent survey by PricewaterhouseCoopers shows U.S. CEOs to be as bullish on M&A as they have been in years.

The end of 2012 saw a flurry of blockbuster M&A deals (e.g., a \$20 billion purchase by Japan’s Softbank of 70% of Sprint, an \$8 billion purchase by IntercontinentalExchange of NYSE Euronext and a \$4.23 billion purchase by a Chinese consortium of 80.1% of International Lease Finance Corp.). This momentum continued through the start of 2013 (e.g., a \$28 billion purchase of Heinz by Berkshire Hathaway and 3G, a \$24 billion leveraged buyout of Dell and a \$16.7 billion acquisition by Comcast of GE’s 49% ownership of NBCUniversal). There is definitely optimism that these deals are harbingers of a stronger 2013 for M&A.

As M&A activity increases, so will the need for acquisition financing. It is important to review the fundamentals of U.S. acquisition financing using secured loans and trends in this regularly changing area of loan financing.

## The Commitment Letter is Key

The commitment letter for a financing sets forth the material terms of the lenders’ obligation to fund the loans and the conditions precedent to such obligation. It is of particular importance to acquisition financing and the strength of a commitment letter can be the deciding factor as to whether a seller will sign an acquisition agreement with a particular buyer where the buyer cannot otherwise prove itself able to fund the acquisition from its own funds. As in all committed financings, the borrower wants an enforceable commitment from its lenders which obligates the lenders to extend the loans. In acquisition financing, where the proceeds of the loans will be used by the borrower to pay the purchase price for the target company, the seller will also be concerned that the buyer has strong funding commitments from its lenders. If the buyer’s lenders do not fund the loans, a failed acquisition could result.

In a typical timeline of an acquisition, especially one involving public companies, the buyer and seller execute the definitive agreement for the acquisition weeks, if not months, in advance of the acquisition. Following execution, the buyer and seller work to obtain regulatory approvals and other third-party consents that may be needed to consummate the acquisition, execute a tender offer if required, complete remaining due diligence, finalise the financing and take other required actions. Signing an acquisition agreement often results in the seller not pursuing other potential buyers for a period of time while the parties work to complete the items noted in the prior sentence. For example, acquisition agreements often contain covenants forbidding the seller from soliciting other bids and requiring the parties to work diligently towards closing. Further, many acquisition agreements do not give the buyer a right to terminate the agreement if its financing falls through (known as a “financing-out” provision). Accordingly, at the signing of the acquisition agreement, and as consideration for the seller’s efforts and costs to close the acquisition, the seller will want the lenders to have strong contractual obligations to fund the loans needed to close the acquisition.

## Who Drafts the Commitment Letter?

Private equity funds (also known as sponsors) are some of the most active participants in M&A transactions and related financings. With their sizable volumes of business that can be offered to banks, sponsors often have greater leverage in negotiations with lenders than non sponsor-owned companies. Sponsors and their advisors monitor acquisition financings in the market and insist that their deals have the same, if not better, terms. As economic tides shift, the sponsors’ ability to leverage their large books of banking

business grows and wanes, and the favourability for sponsors of acquisition financing terms shift as well.

Who drafts the commitment papers is one area where sponsors are often treated more favourably than other borrowers. While lenders in most cases want to draft commitment papers, the larger sponsors are now regularly preparing their own forms of commitment papers and requiring the lenders to use them. From the sponsors' perspective, controlling the drafts can result in standardised commitment letters across deals and a more efficient and quick process to finalise commitment letters. To get the best terms, the sponsors often simultaneously negotiate with separate potential lenders and then award the lead role in an acquisition financing to the lender willing to accept the most sponsor-favourable terms.

### Conditionality

The buyer's need to show certainty of funds to pay the purchase price puts sharp focus on the conditions that must be met before the lenders are contractually obligated to fund the loans. Limiting the number of conditions precedent in a commitment letter, and being explicit as to the included conditions, is a key mechanism to lessen funding uncertainty. The buyer and seller want to avoid a scenario where the conditions precedent to the buyer's obligation to close the acquisition have been met but the lenders' obligation to fund the loans have not. If, in that scenario, no financing-out clause is included in the acquisition agreement, the buyer may not be able to close the acquisition and could be required to pay the seller sizable contractual breakup fees and be subject to lawsuits from the seller. Certain conditions discussed below are commonly subject to heavy negotiation in an acquisition financing.

### Documentation Conditions

Commitment letters for general financings often contain vague and partial lists of documents and conditions that the lenders will require before funding the loans. Phrases like "customary conditions precedent" are often seen. In contrast, a commitment letter for an acquisition financing typically has an explicit, detailed and often lengthy list of conditions.

If the lenders are permitted to require satisfaction of conditions precedent to funding that are not contemplated by the signed commitment letter (whether customary conditions or not), this increases the risk to the borrower that these additional conditions cannot be met. It is common in an acquisition financing to see an express statement from the lenders that the list of conditions precedent in the commitment letter are the only conditions that will be required for funding. Many lists of conditions precedent in commitment letters for acquisition finance are so detailed that they are copied directly into the final forms of loan agreements.

Similarly, vague references to "customary covenants" and "customary events of default" in a commitment letter add risk that the lenders will require that the loan agreement include unreasonable provisions which could not be met by the borrower. To limit this risk, commitment letters for acquisition financings often include fully negotiated covenant and default packages (which may include pages of detailed definitions to be used in the calculation of any financial covenants).

Some sponsors even require that the form of the loan agreement be consistent with "sponsor precedent". Requiring the lender to use the sponsor's most recent loan agreement as a model for the new financing limits the risk to the sponsor that the financing will be delayed or not close because the lender produces a draft loan agreement with off-market or unusual clauses.

### Representations and Warranties

Loan agreements typically require that the representations and warranties included in the loan agreement be accurate as a condition to funding. Lenders financing the acquisition also want the representations with respect to the target in the acquisition agreement to be accurate. This is reasonable because after consummation of the acquisition, the target is likely to be obligated on the loans (either as the borrower or a guarantor) and thus part of the credit against which the lenders are funding.

"SunGard" (named for an acquisition financing that included these terms) or "certain funds" provisions are now common in commitment letters for acquisition financings. These clauses are relevant to several provisions in a typical commitment letter. With respect to representations and warranties, these clauses provide that on the closing date of the loan, as a condition to the lenders' funding obligations, only certain representations need to be accurate. Strong sponsors sometimes even negotiate the precise meaning of the term "accurate". The representations required to be accurate as a condition to the lenders' funding obligation in a typical SunGard clause include the following:

- (i) Only those representations in the acquisition agreement relating to the target that, were they untrue, would be material to the lenders and for which the buyer has a right under the acquisition agreement to decline to close the acquisition must be accurate. While providing certainty of funding, this standard avoids a scenario where the loan agreement has different representations with respect to the target than the acquisition agreement.
- (ii) Only certain representations with respect to the borrower set forth in the loan agreement must be accurate (the so-called "specified representations"). These can include those with respect to corporate existence, power and authority to enter into the financing, enforceability of the loan documents, margin regulations, no conflicts with law or other contracts, solvency, status of liens (but see below regarding this topic) and certain anti-terrorism and money laundering laws. A financial covenant could also be included as a specified representation in some deals. What are included as specified representations change with changing economic conditions and relative bargaining strength of companies and sponsors. As financial markets have improved and the leverage of sponsors has increased, the typical list of specified representations has shrunk and may well continue to weaken, benefiting sponsors.

These are the only representations applicable as conditions precedent to the initial funding of the loans. Even if the other representations in the loan agreement could not be truthfully made at the time of the initial funding, the lenders nonetheless are contractually obligated to fund the loans.

### Company MAC

Company material adverse change (MAC) is a type of representation included in some acquisition agreements and loan agreements. This is a representation that no material adverse change in the business of the target has occurred. Inability to make the representations in the acquisition agreement typically permits the buyer to terminate the acquisition agreement and in the loan agreement it excuses the lenders from their funding obligations. A customary MAC definition in an acquisition agreement differs from that in a loan agreement. Acquisition agreement MAC clauses are often more limited in scope and the time-frame covered, and have more exceptions (including for general market and economic conditions impacting the target). Like other representations, buyers

and sellers often require that the MAC definition in loan agreements mirror the definition in acquisition agreements.

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### Market MAC and Flex

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Market MAC is another type of MAC representation in some commitment letters. Seen more in economic down-cycles, these clauses allow the lenders to terminate their commitments if there has been a material adverse change in the loan and syndication markets generally. Strong borrowers and sponsors have had success negotiating these clauses out of their commitment letters over the last several years as the economy has continued to improve.

As discussed above, the time between signing the commitment letter, on one hand, and closing the acquisition and funding the loans, on the other, is often a significant period. Lenders whose commitment letters do not have a market MAC, especially those lenders who fully underwrite the commitments, are subject to deteriorating financial markets during the syndication of the commitments and the risk that they will not be able to sell down the commitments to other lenders. “Flex” provisions limit this risk and allow for amendments to the terms of the financing without the borrower’s consent when necessary to allow the lenders arranging the loan to sell down their commitments.

If, during syndication, there is no market for the loans at a certain price or with certain terms, the committed lenders are permitted to exercise these flex clauses and increase the pricing within pre-agreed limits or make other pre-agreed changes to the structure of the loans. While these changes provide some comfort to committed lenders in gradually deteriorating financial markets, they may not be as helpful in a dramatic downturn where there is little to no market for loans on any terms.

Just after the financial crisis, not surprisingly, flex clauses often became broader in scope and gave lenders greater flexibility to change key terms of a financing. The types of provisions that can be subject to flex include interest margin, negative covenant baskets, financial covenant ratios, the allocation of credit between first lien, second lien and high yield bonds and the amount and type of fees. As markets continue to improve, sponsors are using their leverage to limit flex provisions, including the financing terms subject to the flex provisions, and requiring greater limits on the scope of the changes that can be made without their consent.

Some sponsors have even turned the tables on their lenders and require “reverse flex” arrangements. These require the lenders to amend the financing terms under the commitment letters to be more favourable to the borrower if syndication of the loans is so successful that there are more potential lenders than available loans.

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### Perfection of Liens

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Like in all secured financings, lenders in an acquisition financing need evidence that their liens on the borrower’s assets are perfected and enforceable following the borrower’s default under the loan agreement. Ensuring perfection of the liens is often highly technical and can be a time-consuming process depending on the nature and location of the borrower’s assets and the specific legal requirements for perfection. The technical nature of lien perfection raises the risk that lenders will withhold funding for the loans because insufficient steps were taken to perfect the liens.

Another aspect of a typical SunGard provision limits this risk by requiring delivery at funding of only (i) Uniform Commercial Code financing statements which perfect a security interest in personal property that can be perfected by filing and (ii) original stock

certificates for any pledged shares. Perfecting a security interest in other asset classes is required on a post-funding basis by a covenant detailing what perfection steps are required. The sorts of collateral perfected on a post-closing basis can include real estate, deposit and securities accounts, intellectual property, foreign assets and other more esoteric collateral requiring more complicated efforts.

As financial markets continue to improve, sponsors are likely to continue pushing lenders to increase the time frames to complete post-closing collateral deliverables, give the administrative agent greater flexibility to extend these time frames without lender consent and limit efforts by lenders to increase the collateral deliverables required at closing.

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### The Acquisition Agreement Matters

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Delivery of the executed acquisition agreement is a condition precedent to the lenders’ obligation to fund the loans. The terms of the acquisition agreement are important to lenders in a number of respects beyond understanding the structure and business of the borrower after consummation of the acquisition. Lenders also regularly require inclusion of certain provisions in acquisition agreements.

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### Structure of the Acquisition

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The structure of the acquisition is important to the lenders as it will dictate a number of issues for the financing, including collateral perfection, identity of the guarantors and borrowers and timing of the acquisition (i.e., how long the lenders need to have their commitments outstanding). There are a number of common acquisition structures. While the specifics of those structures are beyond the scope of this chapter, these include stock purchases (with or without a tender offer), mergers (including forward, forward triangular and reverse triangular mergers) and asset purchases. Each has its own unique structuring issues for the lenders.

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### Representations and Company MAC

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As described above, the lenders often rely on the representations and warranties in the acquisition agreement, including the definition of material adverse change, and incorporate those terms into the loan agreement.

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### Obligation to Continue Operating

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Lenders often review whether the seller is contractually obligated in the acquisition agreement to continue operating the business in the ordinary course and not to make material changes to the business. Again, the target is a part of the lenders’ credit and the lenders do not want to discover after consummation of the acquisition that the target has been restructured in a way that results in its business being different than the lenders’ understanding.

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### Indemnity

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Lenders also typically consider the indemnities provided by the seller in the acquisition agreement. If, after the acquisition is consummated, it is discovered that the seller made a misrepresentation or, worse, committed fraud or other wrongdoing as part of the acquisition, those indemnities could affect the buyer’s ability to recover against the seller. If the misrepresentation or

wrongdoing results in the lenders foreclosing on the assets of the borrower, the indemnities could be inherited by the lenders if the rights of the borrower under the acquisition agreement are part of the collateral.

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### Purchase Price Adjustments and Earn-Outs

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Any payments to be made to the seller by the buyer after consummation of the acquisition are important to the lenders. Many loan agreements define these payments, whether based on performance of the target or other factors, as debt and their payment needs to be specifically permitted by the loan agreement. Beyond technically drafting the loan agreement to permit payment of these amounts, these payments should be viewed as assets of the buyer that are not available to the lenders to repay the loans and this may impact the credit review of the loan facility.

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### Xerox Provisions

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When a proposed acquisition terminates, the commitment letters for the acquisition financing typically state that the lenders' commitments also terminate. That is not always the end of the lenders' concerns. Many terminated acquisitions result in accusations of wrongdoing and bad faith by the parties. Litigation is not uncommon. Lenders want to make sure that any litigation brought by the seller does not look to the lenders for damages.

Xerox provisions (named for a financing with Xerox where these clauses were seen) give lenders this protection in the form of an acknowledgment by the seller in the acquisition agreement that the seller's sole remedy against the buyer and its lenders for termination of the acquisition is the breakup fee specified in the acquisition agreement. If the acquisition terminates because the lenders fail to fund their commitments, the lenders may be subject to a breach of contract suit brought by the buyer. But the lenders in any termination scenario often seek to restrict suits brought against them by the seller. Conversely, sellers' focus on certainty of the financing have caused some sellers to push back on inclusion of these provisions. Some sellers with strong leverage even negotiate for the right to enforce remedies (or cause the buyer to enforce remedies) against the lenders under a commitment letter.

Since the lenders are not party to the acquisition agreement, applicable law creates hurdles for the lenders to enforce the Xerox provisions. To address these hurdles, lenders seek to be expressly named as third-party beneficiaries of the Xerox provisions. In the event the lenders have claims against the seller for breach of the Xerox provisions, lenders will have customary concerns about the venue and forum of any claims brought by the lenders under the acquisition agreement. Like in loan agreements, lenders often seek to have New York as the exclusive location for these suits and seek jury trial waivers in the acquisition agreement.

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### Cooperation with the Financing

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As discussed above, the lenders have an interest in understanding the acquisition and the nature of the target's business. Further, the conditions precedent will require deliverables from the target and the lenders' regulatory, credit and legal requirements demand that they receive certain diligence information about the target and its business. None of this can be accomplished if the seller does not agree to assist the buyer and its lenders. Lenders often require that the acquisition agreement include a clause that the seller will cooperate with the lenders' diligence and other requirements relating to the acquisition financing.

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### Amendments to the Acquisition Agreement

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Lenders usually have the opportunity to review the acquisition agreement, or at least a near final version, prior to executing their commitment letters. The buyer and seller will want the lenders to acknowledge that the final agreement or draft is acceptable. The lenders, on the other hand, will want to receive notice of any amendments to the acquisition agreement and ensure they do not adversely impact the financing. To avoid the lenders' refusal to fund the loans because of an amendment to the acquisition agreement, buyers and sellers are often careful to ensure that no amendments to the acquisition agreement will be required. Some amendments are unavoidable and commitment letters often contain express provisions as to the nature of those amendments that need lender approval. If lender approval is not needed, then the lenders cannot use the amendment as a reason to refuse funding.

Negotiations of the "no-amendment" condition focus on the materiality of the amendments and whether the change has to be adverse or materially adverse, with some lenders negotiating consent rights for any material change in the acquisition agreement. Lenders often seek to negotiate express provisions that would be deemed material or adverse, including some of the above clauses that were included in the acquisition agreement at the requirement of the lenders. Some lenders with strong negotiating leverage even negotiate for a clause in the acquisition agreement that any amendments will require the lenders' consent.

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### Conclusion

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Leveraged acquisitions in the United States raise unique structuring issues and techniques, only some of which are discussed here. As global financial markets continue to improve, expect to see greater volumes of acquisition financings and sponsors exercising greater leverage over their lenders to loosen acquisition financing terms.

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- Telecoms, Media & Internet
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