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Editorial Chapters:

1	**Loan Syndications and Trading: An Overview of the Syndicated Loan Market** – Bridget Marsh & Ted Basta, The Loan Syndications and Trading Association	1
2	**Loan Market Association – An Overview –** Nigel Houghton, Loan Market Association	7
3	**Asia Pacific Loan Market Association – An Overview –** Janet Field, Asia Pacific Loan Market Association	11

General Chapters:

4	**An Introduction to Legal Risk and Structuring Cross-Border Lending Transactions** – Thomas Mellor & Marc Rogers Jr., Bingham McCutchen LLP	15
5	**Global Trends in Leveraged Lending** – Joshua W. Thompson & Caroline Leeds Ruby, Shearman & Sterling LLP	20
6	**Recent Trends in U.S. Term Loan B** – Meyer C. Dworkin & Monica Holland, Davis Polk & Wardwell LLP	26
7	**Yankee Loans – Structural Considerations and Familiar Differences from Across the Pond to Consider** – R. Jake Mincemoyer, White & Case LLP	31
8	**Issues and Challenges in Structuring Asian Cross-Border Transactions – An Introduction** – Roger Lui & Elizabeth Leckie, Allen & Overy LLP	36
9	**Acquisition Financing in the United States: Outlook and Overview –** Geoffrey Peck & Mark Wojciechowski, Morrison & Foerster LLP	41
10	**A Comparative Overview of Transatlantic Intercreditor Agreements –** Lauren Hanrahan & Suhrud Mehta, Milbank, Tweed, Hadley & McCloy LLP	46
11	**Oil and Gas Reserve-Based Lending** – Robert Rabalais & Matthew Einbinder, Simpson Thacher & Bartlett LLP	52
12	**Lending to Health Care Providers in the United States: Key Collateral and Legal Issues** – Art Gambill & Kent Walker, McGuireWoods LLP	56
13	**A Comparison of Key Provisions in U.S. and European Leveraged Loan Agreements** – Sarah M. Ward & Mark L. Darley, Skadden, Arps, Slate, Meagher & Flom LLP	61
14	**Financing in Africa: A New Era** – Nicholas George & Pascal Agboyibor, Orrick, Herrington & Sutcliffe LLP	67
15	**LSTA v. LMA: Comparing and Contrasting Loan Secondary Trading Documentation Used Across the Pond** – Kenneth L. Rothenberg & Angelina M. Yearick, Andrews Kurth LLP	72
16	**The Global Subscription Credit Facility Market – Key Trends and Emerging Developments** – Michael C. Mascia & Kiel Bowen, Mayer Brown LLP	79
17	**Majority Rules: Credit Bidding Under a Syndicated Facility** – Douglas H. Mannal & Thomas T. Janover, Kramer Levin Naftalis & Frankel LLP	83

Country Question and Answer Chapters:

18	**Albania**	KALO & ASSOCIATES: Nives Shtylla	87
19	**Angola**	SRS Advogados in cooperation with Adjuris: Carla Vieira Mesquita & Gustavo Ordonhas Oliveira	94
20	**Argentina**	Marval, O'Farrell & Mairal: Juan M. Diehl Moreno & Diego A. Chighizola	101
21	**Australia**	Clayton Utz: David Fagan	109
22	**Bermuda**	MJM Limited: Jeremy Leese & Timothy Frith	117
23	**Bolivia**	Criales, Urcullo & Antezana - Abogados: Carlos Raúl Molina Antezana & Andrea Mariah Urcullo Pereira	127
24	**Botswana**	Khan Corporate Law: Shakila Khan	134
25	**Brazil**	TozziniFreire Advogados: Antonio Felix de Araujo Cintra	141
26	**British Virgin Islands**	Maples and Calder: Michael Gagie & Matthew Gilbert	147
27	**Canada**	McMillan LLP: Jeff Rogers & Don Waters	154
28	**Cayman Islands**	Maples and Calder: Alasdair Robertson & Tina Meigh	162
29	**China**	DLA Piper: Robert Caldwell & Peter Li	169
30	**Costa Rica**	Cordero & Cordero Abogados: Hernán Cordero Maduro & Ricardo Cordero Baltodano	177
31	**Cyprus**	Andreas Neocleous & Co LLC: Elias Neocleous & George Chrysaphinis	184

Continued Overleaf

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Country Question and Answer Chapters:

32	**Czech Republic**	JŠK, advokátní kancelář, s.r.o.: Roman Šťastný & Patrik Müller	192
33	**Denmark**	Bruun & Hjejle: Jakob Echwald Sevel & Peter-Andreas Bodilsen	198
34	**England**	Skadden, Arps, Slate, Meagher & Flom LLP: Clive Wells & Paul Donnelly	205
35	**France**	Freshfields Bruckhaus Deringer LLP: Emmanuel Ringeval & Cristina Radu	215
36	**Germany**	Cleary Gottlieb Steen & Hamilton LLP: Dr. Werner Meier & Daniel Ludwig	224
37	**Greece**	KPP Law Offices: George N. Kerameus & Panagiotis Moschonas	235
38	**Hong Kong**	Bingham McCutchen LLP in association with Roome Puhar: Vincent Sum & Naomi Moore	242
39	**India**	Dave & Girish & Co.: Mona Bhide	253
40	**Indonesia**	Ali Budiardjo, Nugroho, Reksodiputro: Theodoor Bakker & Ayik Candrawulan Gunadi	259
41	**Italy**	Chiomenti Studio Legale: Francesco Ago & Gregorio Consoli	266
42	**Japan**	Bingham Sakai Mimura Aizawa: Taro Awataguchi & Toshikazu Sakai	274
43	**Korea**	Lee & Ko: Woo Young Jung & Yong Jae Chang	282
44	**Kosovo**	KALO & ASSOCIATES: Vegim Kraja	289
45	**Luxembourg**	Bonn & Schmitt: Alex Schmitt & Philipp Mössner	297
46	**Mexico**	Cornejo Méndez Gonzalez y Duarte S.C.: José Luis Duarte Cabeza & Ana Laura Méndez Burkart	303
47	**Morocco**	Hajji & Associés: Amin Hajji	310
48	**Mozambique**	SRS Advogados in association with Bhikha & Popat Advogados: Momede Popat & Gonçalo dos Reis Martins	317
49	**Netherlands**	Loyens & Loeff N.V.: Gianluca Kreuze & Sietske van 't Hooft	322
50	**Nigeria**	Ikeyi & Arifayan: Nduka Ikeyi & Kenechi Ezezika	330
51	**Peru**	Miranda & Amado Abogados: Juan Luis Avendaño C. & Jose Miguel Puiggros O.	337
52	**Portugal**	SRS Advogados: William Smithson & Gonçalo dos Reis Martins	346
53	**Russia**	White & Case LLP: Maxim Kobzev & Natalia Nikitina	352
54	**Singapore**	Drew & Napier LLC: Valerie Kwok & Blossom Hing	359
55	**South Africa**	Brian Kahn Inc. Attorneys: Brian Kahn & Michelle Steffenini	367
56	**Spain**	Cuatrecasas, Gonçalves Pereira: Manuel Follía & Héctor Bros	373
57	**Switzerland**	Pestalozzi Attorneys at Law Ltd: Oliver Widmer & Urs Klöti	381
58	**Taiwan**	Lee and Li, Attorneys-at-Law: Abe Sung & Hsin-Lan Hsu	390
59	**Thailand**	LawPlus Ltd.: Kowit Somwaiya & Naddaporn Suwanvajukkasikij	398
60	**Trinidad & Tobago**	J.D. Sellier + Co.: William David Clarke & Donna-Marie Johnson	405
61	**USA**	Bingham McCutchen LLP: Thomas Mellor & Rick Eisenbiegler	414
62	**Venezuela**	Rodner, Martínez & Asociados: Jaime Martínez Estévez	425
63	**Zambia**	Nchito & Nchito: Nchima Nchito SC & Ngosa Mulenga Simachela	430

Chapter 9

Acquisition Financing in the United States: Outlook and Overview

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2014 Expected to be a Stronger Year for Mergers and Acquisitions in the United States

In 2014, the United States is expected to see an increased level of mergers and acquisitions activity, especially in the middle market. The market for M&A activity is an important consideration for participants in acquisition financings because the relative volatility or stability of the market can impact the terms of the financing and dictate whether the terms are more favourable to lenders or borrowers.

Although M&A activity in 2013 did not live up to predictions, total dollar value of M&A deals was up, largely because of a few "mega deals", including the $28 billion buyout of Heinz by Berkshire Hathaway, the $25 billion buyout of Dell, Verizon's $130 billion agreement to buy Vodafone, and the $20 billion purchase by Japan's Softbank of 70% of Sprint. The technology sector saw the largest volume of deals in 2013, which in the U.S. included Cisco's $2.7 billion acquisition of Sourcefire and the acquisition of BMC Software for $6.9 billion by a private equity consortium. The momentum in technology M&A continued at the start of 2014 with the announcement of Lenovo's purchase of IBM's server business and Motorola Mobility from Google, for a combined $5.21 billion, as well as Google's $3.2 billion purchase of Nest and VMWare's $1.175 billion acquisition of AirWatch.

M&A activity in 2014 is also expected to heat up in health care, biotechnology and life sciences. In January, GE announced the $1.06 billion purchase of a medical equipment business from Thermo Fisher Scientific and Forest Laboratories announced the purchase of Aptalis Pharma for $2.9 billion. These deals, among others, are indicative of a strong start to the year for M&A activity, albeit non-leveraged.

The middle market is expected to dominate M&A activity in 2014. In a recent survey by KPMG, 77% of U.S. CEOs responded that they expect to close M&A deals this year under $250 million, followed by 12% who expect deals between $250 and $499 million, and 5% who expect to close deals of between $500 and $999 million.

The increase may be for a variety of reasons, including pent-up demand and continued low interest rates. In addition, many corporate balance sheets continue to be flush with cash and 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. Parties are poised to pursue the pipeline of deals that did not close in previous years.

A 2013 change in Delaware corporate law may also fuel the increase in M&A activity. Since Delaware is one of the most common U.S. jurisdictions of corporate organisation, changes in Delaware corporate law can have a wide impact on M&A transactions. New Section 251(h) of the Delaware General Corporation Law (DGCL) allows, in certain circumstances, for the parties to a two-step acquisition to agree that the back-end merger can be closed without shareholder approval if the purchaser acquires a sufficient number of outstanding shares in the tender offer to approve the back-end merger. This is often a simple majority of shares unless the certificate of incorporation requires a super-majority. Previously, a purchaser was required to obtain at least 90% of the outstanding shares before it could complete a merger without shareholder vote. New Section 251(h) will streamline third party acquisition financings for two-step acquisitions because the tender offer and the back-end merger can be closed at virtually the same time, eliminating the risks that lenders face with extended periods of time between the closing of the two transactions. Given that Section 251(h) is in its infancy, it remains to be seen whether this form of merger will be a preferred structure and, when used, whether the financings will reflect reduced fees or other changes to standard terms because of the associated efficiencies.

As M&A activity increases in 2014, so will the need for acquisition financing. It is important to review the fundamentals of U.S. acquisition financing using secured loans and monitor 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' obligations to fund the loans and the conditions precedent to such obligations. Obtaining a suitable commitment letter from one or more lenders is of particular importance to acquisition financing and 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, subject to certain conditions that have been mutually agreed upon. In acquisition financing, where the proceeds of the loans will be used by the borrower to pay the purchase price for the target company, in whole or in part, 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 documentation 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 or otherwise facilitating other bids and requiring the parties to work diligently towards closing. Further, many acquisition agreements either do not give the buyer a right to terminate the agreement if its financing falls through (known as a "financing-out" provision), or require a substantial penalty payment to be made by the buyer if the transaction fails to proceed, including as a result of the financing falling through (known as a "break-up fee"). Accordingly, at the signing of the acquisition agreement, and as consideration for the buyer's efforts and costs to close the acquisition, the buyer 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 for 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. As a result, a buyer has a strong preference to limit the number of conditions precedent in a commitment letter, and to make sure that the commitment letter is explicit as to the included conditions, in order 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 has been met but the lenders' obligation to fund the loans has not. Particularly in the scenario where no financing-out clause is included in the acquisition agreement, if the acquisition financing falls through because the buyer cannot satisfy the conditions in the commitment letter, 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 expressly set forth in 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. In some cases the list 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 calculation of any financial covenants).

Some sponsors even require that the form of the loan agreement be consistent with "sponsor precedent", meaning that the loan documentation from the sponsor's prior acquisition financing will be used as a model for the new financing. Agreeing to use or be guided by "sponsor precedent" limits the risk to the sponsor that the financing will be delayed or not close because the lender and its counsel produce a draft loan agreement with unexpected terms and provisions.

Representations and Warranties

Loan agreements typically require that the included representations and warranties be accurate as a condition of the 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 of the lenders' funding obligations, only certain representations need to be accurate. Strong sponsors even negotiate the precise meaning of the term "accurate". The representations required to be accurate as a condition of the lenders' funding obligation in a typical SunGard clause include the following:

- 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 from the acquisition agreement.

- Only certain representations with respect to the borrower set forth in the loan agreement must be accurate (the "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 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, but solely for purposes of the initial funding of the acquisition loans (and not for ongoing draws under a working capital revolver, for instance).

Market MAC and Flex

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 (with respect to either interest rate, fees or both) within pre-agreed limits or make other pre-agreed changes to the structure of the loans (such as call protections, shorter maturities, etc.). 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 to require 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 required "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.

Perfection of Liens

As in all secured financings, lenders in an acquisition financing need evidence that their liens on the borrower's assets are perfected and enforceable, preferably as a condition precedent to the initial funding under the loan agreement. However, 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, and in an acquisition financing timing and certainty are at a premium.

Typical SunGard provisions limit 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.

The Acquisition Agreement Matters

Delivery of the executed acquisition agreement is a condition precedent to the lenders' obligation to fund the loans. As discussed in more detail below, as a fallback, lenders sometimes accept a near final draft of the acquisition agreement, coupled with a covenant from the buyer that there will be no material changes. 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.

Structure of the Acquisition

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.

Representations and Company MAC

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.

Obligation to Continue Operating

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 from the lenders' understanding.

Indemnity

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. Acquisition agreements typically contain anti-assignment and transfer provisions. It is important that those provisions expressly permit the lenders to take a lien on the acquisition agreement.

Purchase Price Adjustments and Earn-Outs

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.

Xerox Provisions

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, the sellers' focus on certainty of the financing has 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.

Efforts to Obtain the Financing

Lenders will consider provisions in the acquisition agreement regarding the buyer's obligations to obtain financing. Typically, buyers agree to use "reasonable best efforts" or "commercially reasonable efforts" to obtain the financing in the commitment letter. These provisions may include a requirement to maintain the commitment letter, not to permit any modification to the terms of commitment letter without the seller's consent (with some exceptions), to give notice to the seller upon the occurrence of certain events under the commitment letter, and obtain alternative financing, if necessary. As noted above, acquisition agreements may also contain provisions obligating the buyer to enforce its rights against the lender under the commitment letter, or even pursue litigation against the lender. Buyers with strong leverage will want to limit provisions in the acquisition agreement requiring specific actions against the lenders.

Cooperation with the Financing

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.

Amendments to the Acquisition Agreement

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.

Conclusion

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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