

Acquisition finance in the UK (England and Wales): overview

November 2017

MARKET OVERVIEW AND METHODS OF ACQUISITION

Acquisition finance market

1. What parties are involved in acquisition finance?

After a busy 18 months, the second half of 2016 saw the start of a slowdown in activity in the European M&A debt financing market, as the prospect of Brexit and the election of President Trump in the US, among other factors, fostered a new wave of uncertainty in the financial markets. Transactions have involved a mix of corporate and private equity buyers, although the largest financings over the last couple of years have predominantly been corporate transactions.

Acquisition finance is mostly arranged and underwritten by local and international banks. The arranging banks may syndicate the debt to other banks and in the case of a leveraged loan facility, institutional investors (such as collateralised loan obligations (CLOs), hedge funds and other funds). However, in recent years larger acquisition loans have typically taken the form of a bridge facility which is refinanced in the public debt markets.

Banks remain the dominant source of primary loans. However, since the financial crisis a number of alternative sources of finance have become available to European borrowers, including loans from direct

lending funds and the US and European private placement markets. For example, the "unitranche" product (that is, a single tranche loan provided by a direct lending fund) has become an increasingly popular way of financing mid-market and smaller leveraged acquisitions. The volume of these products are not significant enough to challenge mainstream loans and bonds. However, they are finding their niche and there is a continuing focus on promoting these as an alternative to bank finance at both EU and member state level.

Methods of acquisition

2. What are the main methods used for acquiring business entities in your jurisdiction?

Asset acquisition

Asset acquisitions are generally used where the buyer wishes to:

- Select (cherry pick) the most valuable or desirable assets.
- Leave behind unwanted liabilities or assets that are not of use.

Negotiating an asset acquisition can lead to higher costs, as the process can be more time consuming than a share acquisition, and there may be a limit as to how many undesirable assets can be left behind. Asset acquisitions may also require consents from third parties who are not directly involved in the transaction, such as suppliers, as

contracts will need to be assigned and novated on an individual basis.

Share acquisition

The acquisition of the entire issued share capital of the target company is generally the preferred method of acquisition of a company or group. When acquiring the target's shares, the buyer obtains the entire company and all of its assets and liabilities. This can save time in terms of negotiation, but can also result in the purchaser acquiring unwanted liabilities which it will have to make provision for and conduct full due diligence in relation to.

Merger

Mergers involving a UK company (for example, where one entity absorbs one or more entities, or where a new entity is formed out of merging entities) are possible under the Companies (Cross-Border Merger) Regulations 2007 (SI 2007/2974). An equivalent process is available across the EEA (the UK regulations implement Directive 2005/56/EC on cross-border mergers of limited liability companies (Cross-border Mergers Directive)).

As the operation of the UK Regulations are underpinned by EU law, the extent to which they will continue to apply in a cross-border context will depend on whether the UK is able to or chooses to negotiate a reciprocal and equivalent regime that will apply post-Brexit. Mergers conducted under the Cross-border Mergers Directive in any event, remain relatively rare.

Other

A hive-down combines both assets and share sale techniques. In a hive-down, the assets

and liabilities of the business to be sold are transferred to a new subsidiary. The shares of the new subsidiary are then acquired by the purchaser. The use of hive-downs is typically tax driven.

STRUCTURE AND PROCEDURE

Procedure

3. What procedures are typically used for gaining acquisition finance in your jurisdiction?

The financing process and the documentation required prior to an offer being made or the sale and purchase agreement being finalised depends on the nature of the acquisition.

The City Code on Takeovers and Mergers (Takeover Code) permits the bidder to announce a bid for a UK listed company only after ensuring that it can fulfil any cash consideration offered (*see Question 12, Funding*).

The offer document must include a confirmation from an appropriate third party (usually the bidder's financial adviser) that the bidder has sufficient resources available to carry out its bid. In practice, this requirement for "certain funds" usually means that, even if the acquisition will be funded from the proceeds of an issue of debt or equity securities, the initial financing will take the form of a bridge loan. The drawing of this bridge loan will be subject only to minimal conditions to satisfy the certain funds requirement (*see Question 12, Funding*).

A purchaser can commit to a private acquisition subject to suitable financing, but usually the acquisition is agreed once the

financing is in place. If the sale proceeds are to be raised via auction, the purchaser will often seek to raise financing to support its bid on a similar "certain funds" basis as would be required in the context of a public acquisition subject to the Takeover Code (see *Question 12, Funding*), to gain a competitive advantage during the auction process and/or to satisfy any requirement imposed by the seller to provide "certain funds".

Loan finance is generally documented initially in a term sheet and the documentation is often quite detailed. If time is short, the acquisition financing can be committed using a short-form and short-term interim facility agreement, which can later be replaced with full-form documentation when practicable.

Stapled finance is sometimes used, most commonly in auction sales. This involves the seller instructing a financial institution (or several institutions) to pre-package the acquisition debt finance and "staple" it (usually in the form of a term sheet) to the information memorandum. The information memorandum is then presented to all or a certain number of potential bidders. The main aim is usually to:

- Speed up the auction process.
- Minimise the seller's execution risk.

Vehicles

4. What vehicles are typically used in acquisition finance?

Acquisitions by financial buyers (often private equity funds) where a significant proportion of the purchase price is debt

financed are referred to as leveraged buy-outs (LBOs). The business of financing these transactions is referred to as leveraged finance. In an LBO, the acquisition is typically structured so that the seller has limited recourse to the financial buyers. The debt and equity financing for the acquisition is contributed to a newly formed company (a "Newco") which is used to acquire the target. The debt financiers' recourse is limited to their secured claims against Newco and its group (including the target group).

Limited recourse is not usually a consideration in relation to corporate acquisitions. Corporate buyers typically raise funds and acquire the target directly.

EQUITY FINANCE

5. What equity financing structures are typically used in acquisition finance?

A UK listed company can issue shares to fund an acquisition by a:

- Rights issue.
- Open offer.
- Placing.

Rights issues and open offers are offers to existing shareholders on a fully pre-emptive basis. Placings involve the placement of shares on a targeted and non-pre-emptive basis. Placings are quicker and simpler and are therefore a useful means of raising equity finance for smaller acquisitions.

The equity component of a leveraged acquisition financing can take various forms including equity and shareholder loans.

DEBT FINANCE

Structures and documentation

6. What debt financing structures are typically used in acquisition finance?

Debt financing structures

The type and complexity of the financing arrangements depend on the purchaser, the target and the relevant business sector. Corporate acquisitions are typically debt financed using either:

- Pre-existing loan facilities.
- Newly arranged acquisition facilities.

Bonds can be used to finance large acquisitions, but are generally used in conjunction with a bridge loan, which is refinanced out of the proceeds of the bond issue on or after the acquisition has been completed.

Bridge loan facilities are intended to be short term and are therefore structured to encourage swift refinancing. They are only available for drawdown for a short period in order to permit the completion of the acquisition and (in practice) tend to be refinanced before they are drawn. The maximum tenor is around 24 months, typically comprising an initial term of 12 months, subject to one or two extension options. Extensions (if applicable) are generally automatic and do not require lender consent, although they are likely to be subject to compliance with the representations and undertakings in the loan agreement, the absence of any event of default and the payment of an extension fee.

Leveraged acquisitions tend to involve more complex and secured debt structures. The debt finance can take the form of senior loans or a combination of senior and junior (mezzanine) loans. Additional tranches including second lien and PIK loans are seen occasionally.

Currently, a combination of loans and high-yield bonds is often the preferred approach for transactions where the required volume of debt is sufficient to support a bond issue. There are multiple possibilities for combining term loans and bonds. As in the corporate market, the term loan can be a bridge which is refinanced on or shortly after closing with the proceeds of a high-yield bond issue, leaving any revolving credit facilities (which are usually conferred a super senior claim on any shared security) as the only loan facilities in the structure. Alternatively, secured term loans may be drawn alongside a *pari passu* senior secured high-yield bond, each with an equal claim on any shared security package. Senior secured term loans and/or senior secured bonds may also be used in conjunction with unsecured or subordinated high-yield bond issues.

Equity kickers were a popular feature prior to the 2008 financial crisis. However, they are less common after the financial crisis and generally do not feature in large deals.

Documentation

English law loan documentation (whether for acquisition or general corporate purposes) commonly adopts the recommended forms of facility agreement published by the Loan Market Association (LMA) as its starting point. The LMA does not publish a specific form of corporate acquisition financing facility

agreement. However, the LMA collection does include:

- A form of senior term facility agreement for leveraged acquisition financing.
- Inter-creditor agreements for:
 - senior and mezzanine loan financings; and
 - loan and bond financings.

Corporate acquisition facilities are often based on the corporate's existing working capital terms, which are adapted to include:

- The required acquisition mechanics.
- Any additional protections sought by the lenders to address the group's increased leverage.

Private equity sponsors typically have their own preferred forms of facility agreement. These forms may borrow certain features from the LMA's leveraged financing template. However, in recent years, many English law facility agreements have moved away quite significantly from standard norms and are likely to be heavily negotiated (*see below, Term Loan B and covenant-lite loans*).

Investment grade bond terms are reasonably standardised. The high-yield bond market in Europe is predominantly a New York law market. The covenant package will therefore follow the customs of the US high-yield bond market. Standard template high-yield covenants are not available from any trade association or body. However, market practice has established a framework that is widely used. The covenant exceptions and permissions are usually negotiated in some detail.

Term Loan B and covenant-lite loans

In the US, institutionally-led non-amortising leveraged term loans are often referred to as "Term Loan Bs" (TLBs). The TLB market in the US is well established and is predominantly a covenant-lite market.

The defining feature of a covenant-lite loan is that the comprehensive suite of negative covenant restrictions seen in a traditional bank loan is replaced with a set of incurrence-style covenants. These incurrence-style covenants are similar to those typically seen in a high-yield bond indenture. Covenant-lite loans are quite often described as loans that behave like high-yield bonds.

The incurrence covenant model does not:

- Prevent the borrowing group from taking specific actions on an ongoing basis subject to negotiated exceptions.
- Require the borrowing group to maintain any financial ratios or demonstrate periodic compliance.

Instead, the borrowing group is permitted to incur further debt, pay dividends, make payments on subordinated debt and grant security subject to financial parameters that are only tested as and when the action in question is taken. These financial parameters (or "incurrence tests") can comprise the same types of financial covenant ratio (for example, leverage) used in a traditional bank loan, but are used in a very different way and generally coupled with a number of other exceptions and baskets.

The covenant-lite model is therefore much less restrictive from the point of view of the

borrowing group. It is designed to allow the group to evolve subject to maintaining its overall leverage and debt service profile. Rather than shaping the group's movements, the covenants act as a brake if the company decides to take any restricted action that increases the investors' credit risk beyond the agreed limits.

Covenant-lite loans also have further advantages to borrowers and sponsors, as follows:

- They are permitted more flexibility to run their business without the continuing need for lender consents (and related fees).
- Covenant-lite loans offer the benefits of a high-yield bond without the public reporting requirements.
- For issuers who access both the loan and the bond market, it is convenient to have consistent terms across their debt package.

In the period following the 2008 financial crisis, a number of European issuers borrowed on New York law covenant-lite terms in the US loan market, which during that period offered better relative value as well as more flexible terms than its European counterpart. As liquidity returned to the European market, financial sponsors sought to borrow on the same terms in Europe as they were able to in the US and European covenant-lite loan terms were developed. The re-emergence of a US-influenced covenant-lite product and the establishment and growth of the TLB market in Europe is one of the most notable developments in European acquisition finance in recent years.

Rather than being written in the US style, European covenant-lite typically uses the

broad framework of an LMA loan agreement as its starting point. The LMA financial covenants are removed and the negative covenant package is either adapted to incorporate incurrence style permissions or replaced entirely with a schedule of high-yield bond style covenants. In most cases, the facility documentation is governed by English law. Where high yield-style covenants are adopted, for consistency, the covenant schedule is usually governed by New York law.

European covenant-lite is similar, but not identical in all respects to the New York law product. There also remains some variation in the terms that are achieved deal-to-deal. Further, in a European context, the term "TLB" does not necessarily denote a covenant-lite loan in the sense described above. The market also encompasses a variety of leveraged term loans with more flexible terms than those which have traditionally been applied to European leveraged loans. European TLB may be covenant-lite, but the term TLB may also be used to encompass a "covenant-loose" loan, that contains limited maintenance covenants accompanied by some of the other features more usually associated with a covenant-lite loan (for example, the ability for the group to incur further debt).

This more recent wave of covenant-lite terms have been in general available largely to stronger credits at the upper end of the market, but over the last 12 months the prevalence of such deals has increased.

Inter-creditor arrangements

7. What form do inter-creditor arrangements take in your jurisdiction?

The relative priorities of the different classes of creditor can be established by the use of either:

- Structural subordination, which involves the structurally-subordinated creditors lending at a higher level in the group structure than the senior creditors.
- Contractual subordination, where the creditors document the agreed ranking among themselves in an inter-creditor agreement.

The parties to the inter-creditor agreement generally include each class of finance provider (for example, senior lenders, hedge counterparties, high-yield bondholders and any providers of intra-group debt or intra-group loans which downstream any equity contributions into the borrowing group). In larger transactions, the recommended forms of inter-creditor agreement published by the Loan Market Association (LMA) are often used as a starting point. However, the LMA templates generally require significant alteration due to:

- Capital structures that are different and often more complex than the assumed transactions contemplated by the LMA templates.
- Increasing demand from private equity sponsors for inter-creditor terms "for life" (that is, terms capable of accommodating additional financing and any future refinancing, without re-negotiation).

To protect the agreed subordination, each creditor group is subject to restrictions on the extent to which they can amend or waive the terms of their debt. To preserve the seniority of the senior creditors' claim, each class of creditor (other than the senior

creditors) is generally restricted in relation to:

- The principal, interest, fees and other payments they are permitted to receive.
- The steps they can take to enforce their debt.

Contractual subordination

The efficacy of contractual subordination provisions between the contracting parties is generally accepted as a matter of English law.

However, contractual subordination arrangements are usually supported by turnover subordination provisions, which provide that if the subordinated creditor receives an amount not in accordance with the agreed subordination arrangement, the subordinated creditor must hold that amount on trust for, and turnover that amount to, the senior creditors. If drafted correctly, turnover provisions are beneficial for senior creditors, as they should eliminate their insolvency risk on the junior creditors.

Structural subordination

Structural subordination is often employed in leveraged financing. High-yield bonds can be structurally subordinated to any senior loans or senior secured bonds. If payment-in-kind (PIK) notes or loans are used, these are also typically structurally subordinated to the other external debt in the capital structure.

The impact of structural subordination is weakened if, for example, the parent company higher in the structure on-loans the proceeds of the structurally subordinated debt to the subsidiary which issues the senior debt, as the parent will then have a *pari*

passu claim against the subsidiary. For this reason, structural subordination is usually coupled with contractual subordination arrangements. Therefore, structurally subordinated creditors (or their representatives) will also sign the inter-creditor agreement.

Payment of principal

Typically, both scheduled payments of principal and voluntary and mandatory prepayments of principal for the senior debt (whether that comprises loans, bonds or both) are permitted in accordance with terms of the relevant senior debt. Payments of interest and fees on the senior debt are also unrestricted.

In leveraged financing structures, hedge counterparties usually have a senior or super-senior ranking claim to the same security package as the providers of the senior debt (whether that comprises loans, bonds or both). Scheduled payments due to any hedge counterparty under the terms of the hedging agreements are therefore permitted, although the circumstances in which the hedging transactions may be closed out will be subject to controls.

Typically, junior lenders are entitled to payments of cash pay interest, fees and indemnity payments in accordance with the terms of their debt, but their rights to receive payments of principal are heavily restricted. For example, in a senior/mezzanine loan structure, the mezzanine lenders are entitled to receive their share of any voluntary or mandatory prepayments only once the seniors are paid. Other prepayments of principal may be

allowed only where the prepayment is the result of:

- The operation of the illegality clause.
- A tax or increased costs claim under the mezzanine loan agreement.

In any event, any payments to the mezzanine lenders will be subject to a payment stop following a senior default (which will occur automatically following a senior payment default, and on notice from the senior lenders following other defaults that are specified as stop events). Sometimes exceptions are negotiated, for example, to enable the mezzanine lenders to bring a claim for restructuring costs in a default scenario, but these are often very limited. The circumstances and duration of a payment stop are usually negotiated.

Broadly similar restrictions on payments and payment stop provisions apply when a subordinated high-yield bond takes the place of mezzanine debt in a leveraged capital structure (the more common position).

Payments to intra-group lenders are generally permitted (as they do not involve cash leaving the group) but are subject to an automatic stop on the occurrence of a default/event of default under the terms of the external creditors' debt documents.

Payments in respect of equity/quasi-equity financing involving cash leakage from the borrowing group are typically subject to strict conditions. These conditions are usually documented outside of the inter-creditor agreement, which will refer back to the

restricted payment covenants in the relevant loan and/or bond documentation.

Interest

See above, *Payment of principal*.

Fees

See above, *Payment of principal*.

Sharing arrangements

If any of the creditors receive a payment (or the benefit of a payment) to which they are not contractually entitled in accordance with the inter-creditor agreement, a turnover trust or claw-back mechanism generally ensures that the prior ranking creditor (or security trustee on his behalf) is able to recover the relevant amount from the junior creditor (see above, *Contractual subordination*).

Secured lending

8. What security and guarantees are generally entered into for an acquisition financing?

Extent of security

Investment grade acquisition financings may be guaranteed but can be provided on an unsecured basis.

Financings for sub-investment grade/cross-over and leveraged credits usually involve the provision of both guarantees and security to the senior lenders and if applicable, on a second-ranking basis to the junior (mezzanine) lenders.

The implementation of the security package is usually phased as follows:

- Before the closing date, the lenders take security over the shares in the acquisition vehicle and its rights under the acquisition agreements.
- After the closing date, the acquisition vehicle grants the security over the shares of the target.

The remainder of the transaction security (which comprises both share security and asset security provided by the target and members of its group) is put into place within an agreed period from the date of closing, in accordance with a set of "agreed security principles" (that is, principles outlining the security sought and the considerations to be taken into account in determining whether security should be provided). Guarantees are provided on a similar basis and are normally required from all "material companies". Material companies may be named companies in the target group. However, they are more commonly defined as all companies that represent a minimum percentage of the group's total assets or earnings before interest, taxes, depreciation and amortisation (EBITDA).

The agreed security principles normally provide that security will be granted over all shares and all assets of each company in the acquired group (or each material company) with the exception of where:

- There are legal impediments to doing so.
- To do so would involve disproportionate costs or present significant practical challenges.

If the group involves English companies only, it is legally straightforward to take all-asset security. The main legal impediments can be

dealt with as a practical matter in most transactions.

Any exclusions are likely to be made only on the basis of a cost/benefit analysis and on a negotiated basis. For example, dormant subsidiaries or group companies with no material assets may be excluded. Similarly, if third-party consents are required for the provision of security (such as from landlords in relation to leased real estate or counterparties in relation to book debts and receivables), a commercial decision is required on whether the value of the relevant security asset warrants those consents being pursued.

If the transaction is to be secured, the extent of the security is both a matter for negotiation and (to a certain extent) driven by the nature of the financing. In broad terms, where the debt is financed, or is to be refinanced shortly after closing in the high-yield market, the security package will be structured differently and may be less extensive than if the transaction is financed entirely in the covenanted loan market. Where the security is ultimately intended to benefit high-yield bondholders, the issuer group will generally be divided into:

- Restricted subsidiaries.
- Unrestricted subsidiaries.

Unrestricted subsidiaries are excluded from most of the contractual restrictions in the bond indenture and do not provide guarantees or security. The concept of a "restricted subsidiary" is broader in application than the concept of material companies referred to above (which is more

common in the loan market as a means of defining guarantee/security coverage). This approach to the provision of security and guarantees (the designation of restricted and unrestricted subsidiaries to determine the scope of the security package) is also often used in the covenant-lite TLB market (*see Question 6, Debt financing structures*).

Types of security

The choice of security interest depends on the nature of the asset and its importance in the context of the security package. Secured acquisition finance typically involves a combination of mortgages and charges.

Mortgages involve the transfer of title to the asset to the mortgagee by way of security, with a right to the transfer back of the mortgaged property when the secured obligation is satisfied. A mortgage can be legal or equitable (depending on whether legal or equitable title has been transferred). The form of transfer will depend on the nature of the asset in question. Mortgages over claims or receivables, for example, involve the assignment of rights by way of security.

Lenders do not generally require the more complex steps required to transfer legal title to an asset by way of legal mortgage to be taken in respect of all security assets at the outset of the transaction. In general, only the following are the subject of legal mortgages:

- Freehold property.
- Significant items of tangible moveable property.
- Aircraft and ships.

In relation to other types of asset, equitable security is created and the secured creditors rely on contractual further assurance clauses and a security power of attorney to enable the transfer of legal title on the security becoming enforceable.

A charge involves an agreement by the chargor that certain of its property be charged as security for an obligation. It is a security interest which entails no transfer of title or possession to the chargee. In practice, there is little to distinguish a charge from an equitable mortgage, as the enforcement rights of a mortgage (such as the power to take possession, to sell the secured assets, and/or appoint a receiver) are routinely included in documents creating charges. More significant is whether the charge should be a:

- **Fixed charge.** This attaches to a specific asset and restricts the chargor from dealing with (for example, disposing of) that asset.
- **Floating charge.** This attaches to a class of assets and the chargor is permitted to deal with those assets in the ordinary course of business without the consent of the chargee pending an event which causes the charge to "crystallise". Most floating charges encompass all of the chargor's assets, whether they are:
 - existing or future;
 - tangible or intangible.

The main consequence of the characterisation of a charge as fixed or floating relates to the ranking of payments on insolvency. For example, the expenses of both liquidations and administrations are paid out of floating charge assets. These

expenses can be very considerable and may exhaust all the floating charge assets. A floating charge also ranks behind certain claims of certain preferential creditors (broadly, certain rights of employees) and, in respect of charges created on or after 15 September 2003, the "prescribed part", a ring-fenced fund, capped currently at GB£600,000, is also paid out of floating charge assets to unsecured creditors in priority to the floating chargee.

The other key difference between fixed and floating charges is that the holder of a floating charge which constitutes a "qualifying floating charge" relating to the whole or substantially the whole of a company's property enjoys privileged appointment rights in an administration. This floating charge holder can:

- Appoint an administrator (either in court or out-of-court) at any time when the charge is enforceable.
- Substitute his own preferred candidate for an administrator proposed to be appointed by any other person.

When characterising a charge as fixed or floating, the courts will consider the substance of the relationship between the parties. The label attached by the parties themselves is largely irrelevant and, if inconsistent with the rights and obligations that the parties have granted to one another, the security will be re-characterised.

English law security for acquisition financing typically takes the form of a debenture, which purports to take fixed security over as many of the chargor's assets as possible, together with a floating charge to sweep up

other assets of the chargor. The following is a broad indication of the nature of the security typically taken over various types of asset pursuant to a debenture.

Shares. Security over registered shares usually takes the form of an equitable mortgage or fixed charge. A legal mortgage of shares requires the transfer of legal ownership which can have adverse tax and accounting consequences for the lenders. To facilitate enforcement, the certificates for the shares are usually deposited with the chargee together with signed but undated forms of transfer. If necessary, the target's articles of association (articles) are amended to ensure there are no restrictions on transfer in the event of enforcement.

Inventory. Security over a company's circulating assets is (by definition) encompassed within the floating charge.

Bank accounts and receivables. The appropriate method of taking security over claims and receivables such as book debts, bank accounts and cash depends on whether it is practical to create fixed security. If the intention is to create a fixed charge, the security document must contain adequate restrictions on the chargor's ability to deal with both the asset and its proceeds, and those restrictions must be complied with in practice. This generally means that the proceeds of charged receivables must be paid into a blocked account. This may be achievable in relation to certain specific sums (for example, the proceeds of certain disposals and other amounts that are required to be applied to prepay the loans). However, companies will need to have access to at least some of their bank accounts, so

fixed security will not be achievable in all cases.

Intellectual property rights. These rights are more commonly the subject of a charge. A legal mortgage or assignment of the rights to intellectual property by way of security necessitates an exclusive licence back to the assignor to enable it to continue to use the rights, including a provision for re-assignment on discharge of the security.

Real property. Legal mortgages can be taken over freehold property, depending on its value. Title is transferred to the mortgagee in writing alongside the title deeds if a legal mortgage is to be created. An equitable mortgagee will also generally request delivery of the title deeds.

Movable assets. Significant items of tangible moveable property can be the subject of a legal mortgage, but are more commonly the subject of equitable security for the reasons given above.

Limitations on the validity of security and guarantees

Subject to limited exceptions, security interests created by English companies must be registered at Companies House within 21 days of creation, regardless of whether they are granted:

- Over assets located in the UK or in a foreign jurisdiction.
- Under an English law or foreign law security document.

If this is not done, the security will be void as against a liquidator, administrator or creditor of the company and the secured liabilities

will become immediately repayable. Other than registration, the main considerations in terms of the validity of security are the presence of corporate benefit and the claw-back rules under the insolvency regime, as well as the financial assistance rules (see 10.).

Corporate benefit is analysed on a company-by-company basis. The perceived benefits are recorded in the security provider's board minutes. A transaction that might otherwise fall outside the scope of the directors' powers can be ratified by a unanimous shareholder resolution. Secured creditors usually require such a resolution to be passed by each provider of upstream or cross-stream security as a condition precedent to funding.

Security provided by an English company or any foreign company subject to English insolvency proceedings is at risk of being challenged by the insolvency officer if both:

- It is given within a certain period of time prior to commencement of liquidation or administration.
- It represents a preference, a transaction at an undervalue or is a voidable floating charge.

To be considered a preference, all of the following must apply:

- The transaction must have been entered into within the specified period.
- The company must have been influenced by a desire to produce a preferential effect.
- The company must have been insolvent (as defined by statute) at the time of the transaction or become so as a result of entering into it.

A voidable transaction at an undervalue must have been entered into within the vulnerable period and the company must have been insolvent (as defined by statute) at the time of the transaction, or become so as a result of entering into it. In practice, this ground for challenge is of relatively limited concern in most secured loan transactions because of the good faith defence that is available. It is therefore a defence if all of the following can be shown:

- The transaction was entered into by the company in good faith and for the purpose of carrying on its business.
- At the time of the transaction, there were reasonable grounds for believing that it would benefit the company.

A floating charge may be set aside except to extent of value given to the company at the same time as or after the creation of the charge. If the parties are not connected, it is a defence if the company was solvent (within the statutory definition) when the charge was created and did not become insolvent as a result of the transaction.

The vulnerability periods are:

- Six months for preferences (two years if the counterparty is a connected person).
- Two years for transactions at an undervalue.
- One year for a voidable floating charge claim (two years if the counterparty is a connected person).

Guarantees

Guarantees are commonly provided in support of English law financings. The legal limitations outlined above in relation to security apply equally to the provision of

guarantees (see above, Limitations on the validity of security and guarantees).

Security trustee

Security trusts are recognised and frequently used in English law financings.

RESTRICTIONS

Thin capitalisation

9. Are there thin capitalisation rules in your jurisdiction? If so, what is their impact on an acquisition finance transaction?

A company may be thinly capitalised due to either:

- A special relationship between the borrower and the lender.
- A guarantee given by a person connected with the borrower (such as a parent company) in respect of debt advanced by a third party.

Thin capitalisation can therefore impact the deductibility of interest for tax purposes on an acquisition finance transaction, although deals are typically structured to minimise any potential impact as far as possible.

The UK rules require each borrower to be considered according to its own financial circumstances for the purposes of determining the amount which it would have borrowed from an independent lender and whether it should be considered to be thinly capitalised. The assets and income of the borrower's direct and indirect subsidiaries can be taken into account to the same extent that an unconnected lender would recognise them, but the assets and income of other group companies are disregarded.

There is no "statutory safe harbour" under the UK regime by reference to which tax relief is assured. Historically, the HMRC would not generally regard a company as thinly capitalised where the level of debt to equity did not exceed a ratio of 1:1 and the ratio of income (EBIT) to interest was at least 3:1. However, current guidance moves away from this to apply the "arm's length" standard on a case-by-case basis and sets out broad principles that should be considered, including the applicable leverage ratio (debt to EBITDA).

Financial assistance

10. What are the rules (if any) concerning the prohibition of financial assistance?

The Companies Act 2006 restricts the provision of financial assistance for the purpose of:

- The acquisition of the shares of the target.
- The reduction or discharge of a liability incurred for the purpose of the acquisition of the shares of the target.

The following are prohibited from providing financial assistance:

- If the target is an English public company, the target and any of its subsidiaries (whether public or private).
- If the target is a private company, any English subsidiaries of the target that are public companies.

A number of exceptions apply but they are often not relevant in the context of acquisition finance. In practice, if security and guarantees are required from the target

group then, post-acquisition, the relevant public companies in the target group will be re-registered as private companies before the financial assistance is given.

Regulated and listed targets

11. What industries are regulated in your jurisdiction? How can the fact that a target is a regulated entity affect an acquisition finance transaction?

Regulated industries

If competition issues arise, the Competition and Markets Authority or the European Commission may have jurisdiction over an acquisition or merger in any sector. Similarly, if the bidder is a listed company, the requirements of the UK Listing Rules (which, for example require that shareholder consent is sought for transactions within certain parameters) may affect the transaction. If the target is a listed company, the requirements of the Takeover Code will also be relevant (*see 12.*).

In addition, transactions in certain sectors may give rise to specific requirements. UK-regulated industries include the following sectors:

- Utilities (such as water and power).
- Financial services.
- Insurance.
- Media and communications.

Effect on transaction

The effect on the transaction will vary according to the sector. For example, the consent of the regulator may be required and/or sector-specific licence requirements

may need to be complied with. Regulatory compliance by the target group and the maintenance of its required authorisations may need to be addressed in the terms of the debt financing documents (for example, in the representations, undertakings and events of default in the loan agreement).

12. How does the fact that a target is listed impact on a transaction?

Specific regulatory rules

If the target is a listed company, the Takeover Code, which governs the conduct of takeovers and mergers of public companies in the UK, must be complied with. The Takeover Code is administered by the Takeover Panel, which has various statutory powers under Part 28 Companies Act to address non-compliance, including the power to impose financial penalties.

Methods of acquisition

Takeovers of listed companies are structured either as either a:

- **Contractual offer.** This involves an offer by a bidder to all shareholders, which may or may not be recommended by the board of directors to the shareholders. A contractual offer requires acceptances in excess of 50% of the issued share capital of the target to obtain sufficient control to complete the transaction. In practice, acceptance conditions are often set at a higher level.
- **Scheme of arrangement.** This is usually used for recommended offers only under section 896 of the Companies Act. A scheme of arrangement is initiated by the target company and must be approved by both the requisite percentage of shareholders and the court. A scheme requires the approval of 75% in value of the shareholders present and

voting in person or by proxy at the court meeting to approve the scheme. If the scheme achieves 75% approval, the bidder will automatically acquire 100% of the shares.

Funding

The bidder must announce a bid only after ensuring that they can fulfil in full any cash consideration, having taken all reasonable measures to secure the implementation of any other type of consideration (*General Principle 5, Takeover Code*). The bidder should only announce a firm intention to make an offer if, after careful and responsible consideration, they have every reason to believe that they can and will continue to be able to implement the offer (*Rule 2.7(a), Takeover Code*).

The "cash confirmation" requirement states that if an offeror offers to pay the consideration wholly or partly in cash, their financial advisor must confirm that the bidder has sufficient cash resources available to it to meet this requirement. This confirmation must be incorporated into the offer documentation. Debt or equity financing arrangements intended to finance takeovers must therefore be provided on a "certain funds" basis, which normally means that a loan facility is required to satisfy these requirements, even if the intention is ultimately to finance the offer in the public markets (*see also 3.*).

Market practice, rather than the Takeover Code, dictates the conditions to which a certain funds facility may be subject. In summary:

- The facilities must be underwritten before the offer is announced.

- Most of the typical conditions precedent to the availability of funds must be satisfied when the agreement is signed.

Broadly speaking, to satisfy the certain funds requirement, any remaining conditions must (as applicable):

- Be within the control of the offeror to satisfy (for example, the covenants restricting the incurrence of indebtedness or the creation of security).
- Depend on the offer proceeding (for example, receipt of the required level of acceptances or approval for the scheme).
- Relate to the solvency of the bidder.

The requirements of the Takeover Code with regard to confidentiality affect to whom information regarding a potential offer may be disclosed prior to the bid being announced. The Takeover Code also requires that all shareholders have access to equal information. These rules affect the manner in which debt can be arranged and syndicated both prior to and after the commencement of an offer period. However, they have been in place now for some time and the procedures to be put in place to facilitate compliance are well established.

The Takeover Code also contains a number of requirements with regard to the information that is to be made available publicly regarding the financing of the bid:

- The financing documents must be made publicly available at the time the bid is announced and only very limited aspects are permitted to be redacted.

- The offer document, when subsequently published, must include a description of how the offer is to be financed and the sources of the finance, together with details of any flex rights that remain exercisable and any fees and expenses incurred in relation to the financing.

The main objection to these requirements in practice is the requirement to disclose flex rights (both via the documents on display and in the offer document). Bidders often feel that such rights are commercially sensitive. The Takeover Panel has conceded (when approached) that flex terms do not need to be disclosed at the time of announcement and can therefore be redacted from the documents on display. In effect, however, this only gives the bidder and its financiers a period of up to 28 days between announcement of the firm offer and publication of the offer document for the debt to be syndicated if they desire to avoid the requirement to disclose live flex terms in the offer document, which can be too short a window in many cases.

Squeeze-out procedures

A scheme of arrangement in effect, involves a squeeze-out, which takes place automatically following the requisite approvals being obtained.

In relation to contractual offers, a statutory squeeze-out applies, which entitles the bidder to buy out the minority if the bidder has acquired or unconditionally contracted to acquire both:

- 90% of the shares to which the offer relates.
- 90% of the voting rights in the company to which the offer relates.

Pension schemes

13. What is the impact, if any, of pension schemes held by the target or purchaser on the acquisition?

From the financing perspective, the most significant issues relating to pensions arise on a share sale where the target has, or potentially has, liabilities in relation to a defined benefit (DB) pension scheme. Prospective financiers will be keen to ensure any liabilities in relation to a DB pension scheme (whether current or historic) are taken into account in the purchase price and acquisition documentation.

Financiers will also be focussed on ensuring that the transaction does not trigger action by the Pensions Regulator. Under the Pensions Act 2004, the Pensions Regulator can take action in relation to underfunded DB pension schemes, which includes the ability to require support for schemes from parties "connected or associated" with the scheme employer. Such support can be required by the Pensions Regulator via the service of a:

- Contribution Notice.
- Financial Support Direction.

Acquisitions (in particular those that involve increased leverage) can be a trigger for the exercise of the Pensions Regulator's powers. For example, a Contribution Notice can be issued on the occurrence of an act or omission by the scheme employer or an associated or connected person who has a "materially detrimental effect" on the ability of the scheme to meet its obligations.

Pension scheme trustees and the Pensions Regulator are therefore now often involved in acquisition and financing negotiations, as they will want to ensure that the proposed increase in leverage and the security granted will not have an adverse impact on the rights of the (normally unsecured) pensions creditor. In a number of transactions, DB pension liabilities have resulted in additional contributions to the pension scheme being agreed to enable the transaction to go ahead. In others, the pensions creditor has been granted rights to share in the security package or extracted other forms of credit support from the employer group.

Where DB schemes are a relevant consideration, clearance from the Pensions Regulator is generally sought at an early stage to avoid delay.

LENDER LIABILITY

14. What are potential liabilities of the lender on an acquisition?

The main potential areas of liability for lenders on an acquisition are under:

- Environmental laws.
- Sanctions laws.

There are no environmental laws which expressly impose liability on lenders or holders of security interests in land. However, lenders can incur liability under environmental laws as a result of either:

- Participating in the management of a target group (any persons who "cause or knowingly permit" environmental problems are liable).

- The enforcement of its security (for example, by doing so, the lender may become actively involved in the management of the business).

The absence of any environmental liabilities in the borrower group and its compliance with environmental laws are therefore typically the subject of due diligence and often, representations and undertakings in the facility agreement.

Lenders will want to ensure that their dealings with borrowers do not give rise to any liabilities or obligations under any applicable sanctions regime. This has always been a focus for pre-contract due diligence but aggressive enforcement action and severe penalties imposed by sanctions authorities is increasingly leading lenders to seek additional and specific contractual assurances from the borrower regarding the group's compliance. These will concern both:

- The group's compliance in relation to its business.
- The group's compliance with sanctions laws to which the lenders are subject.

Representations and undertakings on this topic have become common in the UK loan market. The lack of standard wording means they are often the subject of detailed negotiation.

DEBT BUY-BACKS

15. Can a borrower or financial sponsor engage in a debt buy-back?

The ability of borrowers, members of the borrower group or related parties (such as the sponsor shareholders and their affiliates)

to acquire participations in their own loans depends on the terms of the relevant loan.

Whether such buy-backs are possible (and their consequences) was the subject of much debate following the financial crisis, as such transactions gave rise to a number of legal and practical issues under then-current Loan Market Association (LMA)-style loan and inter-creditor documentation, which did not contemplate buy-backs specifically.

In 2008, the LMA amended its leveraged facility documentation to include a provision which sets out the circumstances and the terms upon which (if at all), borrowers, members of the group and/or "sponsor affiliates" are permitted to purchase or otherwise invest in participations in the facilities. Most leveraged facility documentation therefore now specifically addresses both debt buy-backs and the circumstances in which they are permitted.

POST-ACQUISITION RESTRUCTURINGS

16. What types of post-acquisition restructurings are common in your jurisdiction?

Post-acquisition debt restructuring can include the refinancing of bridge loans in the public debt or equity markets. It may also be desirable to conduct a "pushdown" of the acquisition debt into the target group.

REFORM

17. Are there reforms or impending regulatory changes that are likely to affect acquisition finance transactions in your jurisdiction?

Brexit

No significant UK reforms or impending regulatory changes affecting acquisition finance transactions specifically have been announced. However, the legal and regulatory changes that will flow from the UK's departure from the EU (as well as the potential commercial implications of Brexit) have the potential to affect debt finance transactions generally, although whether they will do so in a material way remains to be seen.

The main issue for most regulated financial institutions, in relation to loans and other products, is whether they will be able to continue to offer those products after Brexit if the EU passports on which the provisions of those products currently relies are withdrawn.

Commercial lending, for example, is not a regulated activity in the UK; however that is not the case in all EU countries so there will be transactions where a lender currently holds its commitment and/or participation through its UK entity and lends to borrowers in relevant EU countries in reliance on its passporting rights under the EU Capital Requirements regime. If those rights come to an end (and local regulation in the relevant country requires the lender to be locally authorised to continue to participate in the relevant facility), the lender may need to transfer its commitments to an appropriately authorised local entity or exit the deal.

Current LMA terms provide lenders with a certain amount of flexibility in this regard: transfers and assignments to affiliates do not require borrower consent and lenders are entitled to be prepaid and their

commitments cancelled if it becomes unlawful for them to continue to participate in the facility. Prompted by these concerns, in April 2017 the LMA published an additional "slot-in" mechanic that permits lenders to designate locally authorised affiliates to participate in particular loans under a syndicated facility. This "designated entity" language enables lenders to have appropriately authorised local affiliates ready to step in to take on particular loans, without the need (subject to applicable regulatory requirements) to pre-allocate capital in the relevant countries or undertake a full transfer process.

Other legal risks to which Brexit could give rise (for example, the impact of Brexit on dispute resolution options and the popularity of submissions to the jurisdiction of the English courts, current market practice being underpinned by EU legislation) have also been analysed in some detail. In general, none have prompted changes to documentation terms that are being adopted on a market-wide basis.

In most cases, this is because whether the risk needs to be addressed contractually depends on the outcome of the UK's exit negotiations. For example, after Brexit, the UK will no longer benefit from Regulation (EC) 44/2001 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (Brussels Regulation) that ensures exclusive jurisdiction clauses will be respected by EU member state courts. However, there is thought to be considerable incentive for the remaining EU member states to agree some form of reciprocal arrangement as part of the UK's exit negotiations to ensure their own

judgments remain enforceable in the UK (as well as a number of legal options that the UK may take itself). The general conclusion so far has been that the likelihood of this risk materialising is not sufficiently high as to outweigh the benefits of current market practice. As a result, the need for and extent of any Brexit-related adjustments is likely to require attention in most loan transactions for some time to come (even if the conclusion, as in most cases currently, continues to be that no action is required).

European Central Bank (ECB) guidance on leveraged transactions

The ECB's new Guidance on Leveraged Transactions (ECB Guidelines), which were published in May 2017 and take effect on 16 November 2016, while not part of the UK regulatory regime, are mentioned for completeness as they have the potential to affect the shape of leveraged transactions across the European market as a whole.

The ECB Guidelines are broadly aligned (although not identical) to the US Inter-agency Guidance on Leveraged Lending within which institutions subject to US supervision have been operating since 2013 (US Guidelines). One of the key drivers for the development of the ECB Guidelines (alongside encouraging sound risk management) was the desire to conform the regulatory parameters for European and US leveraged lending. The ECB Guidelines apply to significant institutions within the ECB's supervisory remit and may therefore affect UK institutions to the extent they operate ECB-supervised activities in the EU.

Like the US Guidelines, the ECB Guidelines are not mandatory, nor are they expressed to

stipulate thresholds which financing structures and terms must not cross. Instead, their aim is to ensure relevant institutions employ sound and consistent risk management practices. Nonetheless, they include a number of suggestions in relation to structural or documentation features that regulators would not consider as representative of prudent risk management and which require careful consideration. Therefore, institutions within the scope of the ECB Guidelines are expected to look

carefully at and justify (if not turn down) transactions with those characteristics. In the ECB Guidelines, these features include transactions where leverage is "excessive" (in general, where the total debt exceeds 6x EBITDA) and weak covenant structures.

How lenders active in the European leveraged loan markets might adapt to the ECB Guidelines remains to be seen.

This article was written by Philip Snell and Kathrine Meloni. It first appeared in the Practical Law's Private Mergers and Acquisitions Global Guide 2017/2018.



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