Financing acquisitions of companies in the UK and the US

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Increasingly, the differences between acquisition financings in the US and the UK are decreasing. This is due to the general globalisation of capital markets, and, in particular the introduction to the UK of private equity sponsor financing techniques developed in the US. There are still, however, some significant differences between the two and the most important of these are set out in this chapter, which examines:

- Structuring the acquisition.
- Conditionality and preparation - the need for "certain funds".

STRUCTURING THE ACQUISITION

Achieving 100% acquisitions

A key consideration will be whether the acquisition will be for all or part of the company.

In private transactions the percentage of the shares of the target company that are acquired can be agreed among the parties.

In a "public" transaction where the shares of the target company are widely held, the number of shares acquired depends on the number of shares held by shareholders who accept the bidder's offer for those shares. The desired percentage of shares acquired will depend and vary from bidder to bidder. In some cases it may not even be necessary to acquire more than 50% in order for the bidder to "control" the target. In many cases the bidder would want to go ahead only if 100% of the shares of the target company are acquired.

In the UK, in order to acquire 100% of the shares of a UK target, the bidder will need to obtain acceptances for 90% of the share capital of the target. At 90% or above, the bidder can use a statutory procedure (referred to as the "squeeze out") to acquire the remaining 10% or less of the shares of the target. As a result it will often be a condition to a bid for a public company in the UK that at least 90% of the shares of the target company are acquired.

In the US, the threshold of acceptances required to result in a 100% acquisition is lower than in the UK, usually only 50% or two thirds (with an accelerated short form merger process if a higher threshold (usually 90%) is reached).

Using the target to assist with the financing of the acquisition

Apart from the general business considerations that drive a desire to acquire a minimum percentage of the target's shares, the financing of the transaction may also dictate the minimum required.

In a "leveraged" or "sub-investment grade" transaction, where there is a lot of debt relative to the cash flow generated by the combined bidder and target, the parties providing the financing may insist that the acquisition debt is guaranteed and secured by the target and its subsidiaries.

In the UK, the granting of guarantees or security by a UK company in respect of debt incurred in connection with the financing for the acquisition of the shares in that UK company, or a UK company of which that company is a subsidiary, is considered "financial assistance", and is prohibited unless a "whitewash" procedure is followed.

In order to carry out the whitewash procedure the bidder will effectively have to control 75% or more of the shares of the target company to pass the necessary shareholders' resolutions (which, in the case of a public limited company (plc) will include a resolution to convert from a plc to a private limited company, as only a private limited company is eligible to carry out the whitewash procedure).

In the US, financial assistance is not expressly prohibited, so the 75% minimum does not necessarily apply to allow the US target to grant guarantees and security in respect of the acquisition debt.

In both the UK and the US, however, there are directors' fiduciary duties, rules protecting minority shareholders and corporate benefit requirements. These would have to be considered very carefully before a target company can grant guarantees and security for the debt of a bidder that has not acquired 100% of the shares in the target.

Servicing the interest on the acquisition debt

The bidder and the parties providing acquisition debt will be keen to ensure that, to the extent the bidder does not have sufficient funds, the target will be able to provide cash to service the debt. This cash would usually be provided by way of dividends or loans.

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In the UK, loans to the bidder to assist the servicing of the acquisition debt would, like guarantees and security, be financial assistance and require the whitewash procedure to be completed before the loans can be made.

Even where the whitewash can be done, there is usually a period of time after the acquisition closes and before the whitewash is completed where it will not be possible for the acquisition debt to be serviced by the target. In private equity transactions where the bidder is a new company that does not generate its own cash flow, it would be necessary to provide that there is a credit line, such as a revolving credit facility, that can be used to pay interest until after the whitewash is completed.

In the UK, dividends are not subject to the financial assistance rules but are limited to other rules limiting the ability of a UK company to pay dividends in certain circumstances. It is important to check the ability of a target company to pay dividends if these are an expected source of debt service.

In the US, there are generally fewer restrictions on dividend loans and dividends to service acquisition debt.

Tax

Tax will be a key component of any transaction structuring. The most important interaction with the debt financing is to ensure that the interest payable by the bidder on the acquisition debt is deductible against the taxable profits of the target. In both the US and the UK this can be achieved by ensuring that the bidder and the target can form a tax group, which requires a minimum level of shareholding of the bidder in the target.

In the US, there are tax rules that have an impact on the guarantees and security that can be obtained from target subsidiaries outside the US. This is because guarantees and security from non-US companies in favour of lenders to US affiliates are treated, and taxed on a current basis, like dividends.

These rules generally mean for a US target group that the security outside the US is limited to avoid triggering these rules. For a target group that has an even mix of operations in the US and outside the US, more complex structuring may be required.

CONDITIONALITY AND PREPARATION - THE NEED FOR "CERTAIN FUNDS"

Bid financing conditions - certain funds

In any financing, the borrower will want to have as much certainty as possible that the funds committed by its lenders will be available to be drawn down when needed.

Lenders, on the other hand, want to ensure that the circumstances on which they base their lending decision do not change between making the decision to lend and the time of lending.

In an acquisition financing, the time between the commitment of the banks to lend, usually before the acquisition sale and purchase agreement is signed in a private deal, or before the bid is launched in a public deal, and the time of funding on the closing of the acquisition, can be a long period, particularly if anti-trust or other regulatory approvals are needed before closing.

In a private deal, both in the US and the UK, the conditions to the lenders' obligation to lend can be negotiated on a case-by case-basis, according to prevailing market practice. No well-advised bidder will want to have any conditions in the terms of the acquisition debt, unless they are conditions that the bidder has control over whether or not those conditions are met, or if outside the bidder's control, the same conditions are also conditions to the obligation of the bidder to close the acquisition. In a sellers' market, the conditions included in the sale and purchase agreement will be very limited and, as a consequence, the conditions to the bid financing should be similarly limited.

In a public deal in the US, the position is largely the same as in a private deals, although the added publicity will make bidders and sellers even more reluctant than usual to allow conditions that might result in the bidder being able to "walk away" or, worse, the lenders being able to withdraw their commitment when the bidder is not able to terminate its purchase obligations.

Even so, it is still relatively common in the US for deals to be subject to a "material adverse change" condition which can be invoked by the bidder if, for example, the business of the target is adversely changed, by reference to its own performance or circumstances relating to its business. These conditions are not easy to invoke but can bring about a renegotiation of the purchase price or deal terms if they do not result in the bidder being relieved of its obligations to close the acquisition.

A recent example is the reported dispute arising out of a similar provision in the US$25 billion (about EUR17.3 billion) bid by a private equity consortium for the US mortgage provider Sallie Mae. Some acquisitions in the US, including public deals, include a "financing condition", which would enable the bidder to withdraw if it is unable to obtain financing within agreed parameters.

In a public deal in the UK, the conditions to the bid financing are dictated by the need, under the takeover rules overseen by the Takeover Panel, to show that any funds needed for the bidder to close the bid are available to it on a "certain funds" basis. A reputable bank (often not a member of the syndicate providing the bid financing) will provide a confirmation (referred to as the "cash confirmation") that the bidder has funds available to it to close the acquisition.

As a result, the conditions to the lenders commitments would not be permitted to include a material adverse change condition, and the ability of the lenders to prevent funding will effectively be limited to a deliberate breach by the bidder and an intervening illegality. In recent years, as a result of the competition among bidders and lenders willing to lend, the limited conditions commonly found in a public bid have been seen in bid financings for private deals.

Documentation preparation

Unless the debt financing for an acquisition is really not needed by the bidder, the commitment of the lenders to provide the bid financing should always come before the bidder is committed to the purchase (even where there is a "financing condition"). The way the commitment of the lenders is documented varies according to the type of transaction and the prevailing market.

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In many US deals where there is a "financing condition", and even some where there is no "financing condition", the purchase agreement will be signed or the bid will be launched on the basis of a commitment letter and fairly detailed term sheets.

In the UK, the practice is similar for private deals, but for public deals (and private deals done on a "certain funds" basis) it would be typical for the bidder and the lenders to sign up fully negotiated loan agreements (and often an intercreditor, key security documents and other related documents).

A relatively recent hybrid approach, particularly for deals lead by private equity bidders, is to have a fully committed "interim facility agreement" with a very short maturity (such as 60 or 90 days) and a commitment letter and term sheets for a long term "permanent" financing. This approach was used in the bids for EMI and Alliance Boots at the top of the 2007 bull market.

The interim facility agreement would satisfy the "certain funds" requirements for a public bid but would, due to its short tenor, have virtually no covenants or events of default. Interim facility agreements are not normally expected to be drawn to fund the acquisition as the expectation is that by the time of closing the bid, the commitment letter and term sheets for the permanent financing will be fully documented and implemented.

This approach leaves potential for disagreements between the bidders and the lenders between launching the bid and closing it, and a well advised bidder will, if it takes this approach, want to ensure that the term sheets contain detailed agreement on all but the most mundane boiler plate provisions. The recent "credit crunch" has illustrated that the usual co-operative approach to completing financing documentation can become quite adversarial where the market changes and the lenders are holding commitments for "off market" loans.

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