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IN THE KNOW: INTERNATIONAL

Leveraged Finance Newsletter

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IN THIS TWO-PART SERIES... Baker McKenzie's leveraged finance teams in London and New York consider firstly the importance of funding certainty and how this is created and secondly the available remedies if commitments are not met under both English and New York law documentation.

FINDING CERTAINTY IN UNCERTAIN TIMES

The most important point in any leveraged finance transaction is the certainty that the funds will be there when they are needed.

Borrowers trying to navigate rapidly changing landscapes, including post-COVID valuations and business plans need to know that the debt commitments they secure will still be available when the time for the go/no-go call arrives.

Lenders facing pressure from increased capital adequacy and solvency requirements in the regulated sector and heightened scrutiny from their limited partners in the alternative capital space need to understand exactly when they go on risk for each loan they make.

Whether funding is being made available to implement a recovery plan for a distressed company beleaguered by the economic impact of the COVID-19 pandemic; to fund an acquisition of a business demonstrating a renewed appetite for the changing environment; or simply to offer additional resilience to companies weathering the current economic storm, careful consideration of commitment documentation is crucial.

Equally important is to understand the consequences if committed funds are withdrawn and the remedies that may be available in the event of such a situation arising.

In the first of this two-part series Baker McKenzie reviews how market practice has developed to create contractual certainty in commitment documents for European and US private transactions.

In the second article, Baker McKenzie will consider what remedies are available under New York and English law in the event commitments are not met.

Understanding the differences between these two markets is important for any borrower or lender institution looking to invest in either side of the Atlantic.

Creating Certainty

European Market

"Is the debt done yet?" Every acquisition finance lawyer is familiar with this question. It comes from their M&A colleagues. It comes from seller's counsel. Most importantly, it comes from their client. As we have seen in a previous edition of Baker McKenzie's "In the Know" article in the context of a UK public transaction the answer to this question is regulated by the UK Code on Takeovers and Mergers (the Code). The Code requires that any bidder for the purchase of a public company must be able to demonstrate that it has at its disposal sufficient cash for the purchase to be completed and that this must be confirmed by the bidder's financial advisor who will be liable to make good on any shortfall.

The Code does not apply however in the context of private M&A auctions. Nevertheless, in the European market strong sponsors have imported many of the characteristics of Code compliant financings. Certainty can give a bidder a commercial advantage over competitors and close the gap on strategic/trade buyers that are less dependent on third party sources of capital.

US Market

In the US, there is no regulatory certain funds requirement for any acquisition, whether it be public or private. Bidders are equally focused on demonstrating certainty that they will have the funds available to complete an acquisition. In a typical debt financed acquisition, the seller and buyer will require committed financing to be in place upon execution of the SPA because acquisition agreements do not contain any sort of "financing out" provision; sellers want to have a high degree of certainty that the bidder will be able to fund and close the transaction.

In the US, the financing commitment customarily takes the form of commitment papers rather than a full suite of loan documentation. Commitment papers are executed upon the execution of the merger or acquisition agreement (upon execution).

Notwithstanding the absence of specific regulatory requirements in the US, a comprehensive term sheet is typically attached to the commitment letter which sets forth key terms and other agreed-upon provisions among the parties including key financial definitions, representations, warranties, covenants and events of default. The term sheet will also outline specific baskets and thresholds, set forth leverage levels with respect to the incurrence tests for items such as debt, restricted payments, restricted debt payment and investments.

Negotiating leverage for the borrower is usually highest at the commitment letter stage and so it is customary for borrowers to attempt to lock in as many favorable terms as possible. The commitment letter stage is designed by borrowers to drive lenders to commit to the best terms in order to win the lead role. In larger, syndicated lending transactions, multiple lenders are negotiated with in parallel and combined as close to the end of the process as possible, with roles and economics decided last in exchange for extraction of key concessions.

Private equity transactions will often feature a private equity sponsor precedent that is used as an effective "floor" on important commercial terms. The agreement by lenders to underwrite to a particular precedent further contributes to closing certainty by limiting documentation and execution risk.

Differences and similarities in European and US practice

Similarities

Whether governed by English or New York law, conditions precedent must be satisfied and certain representations and undertakings must be made before a drawdown can occur.

In the context of commitments given to finance an acquisition this conditionality should be limited to those specific requirements that are necessary to implement the contemplated transaction. Usually this means the conditions to funding are limited to:

(i) **the satisfaction of defined key conditions precedent:** such as a share purchase agreement (SPA) and satisfactory 'know-your-customer' checks;

(ii) **the making of a subset of representations:** for example, in relation to the bidder's status and power and authority etc;

(iii) **the application of a narrow group of events of default to the bidder:** for example, insolvency and related events, misrepresentation in respect of key representations (like those referred to above); and

(iv) **unlawfulness.**

The timing of the certain funds period will usually correspond with the timing for completion of the purchase under the SPA and will end upon the occurrence of any 'drop-dead' date in the SPA.

Differences
However, some differences and/or additional requirements have evolved in each market and the reasons for that are set out below under 'Why the difference?'. The differences are:

(i) **provision of an 'interim facility agreement':** private acquisitions in the European market have seen the 'interim facility agreement' become a common feature. These are short-form loan agreements that are put in place to 'bridge' the gap until full form financing documentation can be agreed, thereby minimizing documentation risk almost entirely. They are usually attached to the commitment letter ready to be executed on demand by the borrower and can be utilized at very short notice. In practice, they are very rarely signed let alone drawn but if used will terminate either when full financing documentation is executed or when a back-stop date occurs (typically 30-90 days);

(ii) **inclusion of 'SunGard' provisions:** in the US, commitment papers in respect of acquisition financings do not include an interim facility agreement and will instead include 'SunGard provisions' (named after the 2005 acquisition of SunGard Data Systems by a consortium of private equity firms, which was the first public deal in which these provisions were first adopted). SunGard provisions are designed to assure buyers and sellers that so long as the conditions to closing under the acquisition agreement or the merger agreement are satisfied, lenders will not have any additional "outs" beyond truthfulness of now-standardized specified representations and warranties and a narrow list of limited conditions precedent to closing which are in the control of the buyer; e.g. organizational existence of the borrower and guarantors, power and authority, due authorization, and solvency. There is an alignment of acquisition agreement and debt commitment conditionality through the SunGard provisions and synching up MAC conditions (e.g. definition and lookback date shall match the condition precedent in the acquisition agreement). SunGard provisions are notable not just for the provisions that are included as closing conditions, but also for the provisions which are <u>not</u> included as closing conditions. For example, collateral deliveries are not closing conditions other than with respect to actions in control of the buyer to perfect security interests in the collateral as of the closing date; e.g. filing of UCC-1 financing statements. No diligence conditions are included (business and legal) and there is no lender right of approval over equity documents other than acquisition agreement amendments which are materially adverse to lenders. It is also atypical to have financial tests as conditions (e.g. no minimum EBITDA or maximum leverage conditions). In light of the level of commitment that is implicit in New York law governed commitment papers and the New York law principle of dealing in good faith, there is, as a practical matter, little difference between SunGard commitment papers and European style "certain funds". Nevertheless, it is unlikely that the inclusion of SunGard conditionality would be considered acceptable in a bid delivered in connection with M&A documentation governed by English law and can therefore also raise concerns amongst European sellers in private transactions when assessing the financing behind competing bids; and

(iii) **no material adverse change (MAC):** unlike the European market it is also customary under New York law financings for lenders to benefit directly from a representation that there has been no MAC in the business of the target company. While the inability to make representation in the context of the acquisition or merger agreement will typically permit the bidder to terminate the acquisition or merger agreement, the existence of a MAC in a loan agreement will excuse the lenders from their funding obligations. It is customary in US financings for the bidder and the target company to require that the MAC definition in the loan agreement mirror the definition in the acquisition or merger agreement solely for the purposes of the initial funding of the loans for the purposes of consummating the acquisition.

Why the difference?

Interim facility agreement and documentation risk

There is no general doctrine of 'good faith' in English contract law[1] and English courts have traditionally avoided implying any general duty of 'good faith' into commercial agreements on the grounds that doing so could undermine the long standing

[1] Mid Essex Hospital Services NHS Trust v Compass Group UK and Ireland Ltd (T/a Medirest) [2013] EWCA Civ 200.

principles of contractual certainty and freedom of contract without court interference (except in the case of a breach). In particular, decided case law has demonstrated that agreements to negotiate, even where there is a good faith requirement, are generally unenforceable[2]. Consequently, an agreement to negotiate and agree long form financing documentation is felt to hold insufficient weight and lack enforceability and this gap has been filled by the interim facility agreement.

MAC and other conditionality

US financings typically contain a higher threshold of conditionality when compared to financings in the European market, despite the majority of such conditions being within the borrower's control. It is notable that US financings customarily include a MAC drawstop event with respect to the target which tends to be absent in the European market. As noted above, while this condition in the loan facility will match the MAC condition in the merger or acquisition agreement, it is the lenders who have the ability to determine whether a MAC has occurred on the same terms as that of the bidder. US financings customarily have drawstop events which are substantially similar to those in the European market but tend to be broader in nature, typically including the target group provided that the purchaser also receives corresponding representations from the seller under the merger or acquisition agreement.

The 'hybrid approach'

However, it is worth noting that you may see the use of an interim facility agreement sitting along side US commitment letters in the case where you have a US sponsor backing a bid for an English or European based acquisition. This is because a European seller might be concerned by the different approach towards documentation risk highlighted above. Unlike in the US market, European SPAs are less likely to include (i) "Xerox" language (which limits recourse to the lenders); (ii) extensive financing cooperation provisions (including requirements as to information provision and marketing periods); (iii) extensive financing representations; and (iv) as noted above, a MAC out.

Conclusion

Optically the differences between New York and English law commitment documentation can appear dramatic. However, in the context of their respective M&A market practice and the application of the applicable governing law they can achieve a substantially similar level of certainty provided appropriate considerations are taken. In the next article in this series Baker McKenzie will look at the remedies available if the certain funds do not arrive.

[2] Walford v Miles [1992] 2 AC 128, [1992] 1 All ER 453 and Emagine Films Ltd v Mister Smith Entertainment Ltd [2019] EWHC 2085 (Ch)

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