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Chapter 8

Acquisition Financing in the United States: 2017… Uncertainty!

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Global M&A was sluggish in the beginning of 2016, but ended strong with a fourth quarter burst of activity. While aggregate 2016 deal volumes dropped 16% from the highs of 2015, Thomson Reuters reports that 2016 global deal volume hit US$3.7 trillion, the second highest since the financial crisis. US deal volume, at US$1.7 trillion, reflected a corresponding 17% decline. A significant part of the turnaround from the start of year came in the last quarter of 2016, which had US$1.2 trillion of global deal volume and seven of the top ten deals by size.

Corporate strategic buyers were significantly more active in 2016, often winning competitive M&A bids over private equity funds. Large corporate balance sheets and the difficulty of the regulatory environment for lending were likely factors. Many corporate deals were 2016's largest deals, including AT&T's announced US$107 billion acquisition of Time Warner. Other mega deals included the US$63 billion acquisition of US's Monsanto by Germany's Bayer and the US$30 billion acquisition of UK's ARM by Japan's Softbank.

2016 M&A activity was fairly balanced across industry sectors, with the exception of energy and power, with a 15% increase from 2015, and technology, with a 15% decrease. While 2016 saw many mega deals, global middle market deal volume remained strong at US$931 billion; only a 1.2% decrease from 2015.

Whether 2017 proves to be another strong year for M&A and the lenders that finance deals may be impacted by the uncertainty of global politics. The global economy saw two unexpected political developments in 2016: Brexit in the United Kingdom and President Trump in the United States.

The United Kingdom's vote to exit the European Union was a shock, but the impacts on M&A activity are likely to be first seen in 2017 when Prime Minister Theresa May formally begins the process of exiting the trade union. Intense negotiations between the UK and the EU on the meaning of "exit" are expected. These negotiations will give the corporate sector the first insight to whether Brexit will result in the UK remaining a loose, but unofficial, member of the EU or whether the exit will be more severe and disruptive. 2017 elections in France, Germany, Italy and the Netherlands have the potential to create more uncertainty for the EU and possibly result in additional countries leaving the union. M&A activity involving Europe may slow while the uncertainty of Brexit's impacts is analysed.

The United States, not to be outdone by the uncertainty created by Brexit, upped the ante by electing Donald Trump as its 45th President. In just the first few weeks as President, Mr. Trump has signalled his intent to make major change in many areas that impact M&A deal-making decisions: trade, tax and regulation. Mr. Trump's proposed changes may ultimately result in a US M&A boom. In 2017, however, with the contours of the proposed changes undetermined, there will be uncertainty which could result in slower deal-making, particularly in certain industries.

On trade, Mr. Trump indicates a protectionist policy future that could disrupt established trade channels in the global economy. It is uncertain how far the Republican-led Congress, which is generally pro-free trade, will go to implement a protectionist trade policy. Many large-cap and middle market companies have long worked in the complex global economy and any disruption of these markets could impact M&A activity.

On tax, Mr. Trump and the Republican Congress are in agreement on cutting corporate taxes, including changes to the US tax code that currently discourage US companies repatriating non-US source revenue back to the US. Tax planning is a key to any successful M&A deal, and the uncertainty on corporate tax rates and rules will need to be considered by M&A deal-makers.

On regulation, Mr. Trump and the Republican Congress are in strong agreement to roll back corporate regulations. "We are cutting regulations massively for small business and for large business," said Mr. Trump at the time he executed an order calling for a "two for one" regulatory requirement; for each new regulation, two existing regulations need to be terminated. Mr. Trump has also signed an order indicating a roll back of Dodd-Frank, the post-financial crisis regulation of the finance industry, and Obamacare, the national health insurance law. Uncertainty about the regulatory environment in any given industry may hamper M&A activity.

While "uncertainty" will be a key word for 2017, deal-making should be high, particularly in industries less impacted by political uncertainty. The need for acquisition financing will continue to be strong. It is important to review the fundamentals of U.S. acquisition financing using secured loans and monitor trends in this regularly changing area of financing.

The Commitment Letter is Key

The commitment letter for a financing includes 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 whether 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 routinely 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 "reverse 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 ability of sponsors 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 expect 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 a number of 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 enhance funding certainty. 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.

Conditions Precedent, Covenants and Defaults

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 present similar risks, particularly proposed inclusion of 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).

Form of Loan Documents

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.

Many acquisition financings, particularly in the middle market, involve multiple classes of loans with complex intercreditor arrangements. These financings include 1st/2nd lien, split-collateral, *pari passu* collateral, subordinated, holdco and unitranche financings. In complex and technical intercreditor agreements, lenders agree on many issues relating to their respective classes of loans, including priority of liens, priority of debt, control of remedies and certain technical bankruptcy issues. Negotiation of these agreements among different classes of creditors can be lengthy and frustrate closing time frames. As middle market M&A continues to grow, and more deals have complex intercreditor arrangements, some sponsors are also requiring lenders to use a specified form of intercreditor agreement.

Representations and Warranties

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

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

- The only representations and warranties relating to the target are those 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. While providing certainty of funding, this standard avoids a scenario where the loan agreement has different representations with respect to the target than the acquisition agreement.
- 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 (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, benefitting 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), sometimes referred to as a "company MAC" or a "business 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 or a delayed draw term loan, 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 with excluding these clauses in 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 lengthy 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 certain agreed-upon 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 the price or terms provided in the commitment letter and term sheet, a flex provision will allow the committed lenders to "flex" the pricing terms (by increasing the 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.

At times of financial and market uncertainty, 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 rate margins, 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 improve, sponsors are using their leverage to limit the breadth of 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 provisions 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 "oversubscribed", meaning that there is more demand from 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 (to the borrower and the seller) that lenders will delay or 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 article, 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 than 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 lenders could inherit the indemnities 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, the proceeds to be used to make 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 breach of contract, wrongdoing or 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 first seen) give lenders this protection in the form of an acknowledgment by the seller in the acquisition agreement that the seller's sole remedy against the buyer and its lenders for termination of the acquisition is the breakup fee specified in the acquisition agreement. If the acquisition terminates because the lenders fail to fund their commitments, the lenders may be subject to a breach of contract suit brought by the buyer. But the lenders in any termination scenario often seek to restrict suits brought against them by the seller. Conversely, sellers' focus on certainty of the financing 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. While 2017 promises to be a hard-to-predict year, expect M&A volumes to remain high, with sponsors exercising greater leverage over their lenders to further loosen acquisition-lending terms.

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