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Acquisition Finance

UK
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Law and Practice

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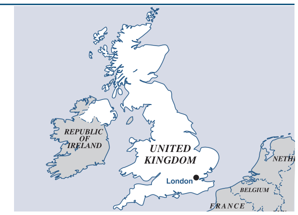

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1. MARKET

1.1 Major Lender-Side Players

Banks remain the dominant source of funding for primary loans, particularly for corporate purchasers. The nature of the acquisition, size of the facility and the identity of the purchaser (especially its credit rating and industry sector) will impact the composition of the syndicate, which will typically feature both local and international banks, particularly in larger cross-border deals. Deals will mostly be arranged and underwritten by banks, with the debt syndicated more broadly post-closing; for leveraged loan transactions, syndication will generally involve institutional investors.

Alternatives to bank finance, such as institutional direct lending, US and European private placements and *schuldschein* (the German private placement market) have become increasingly popular sources of funding for midmarket and smaller acquisitions. Unitranche facilities, for example, allow institutional investors to lend directly to purchasers and can offer a simpler alternative to the traditional senior mezzanine loan structure by combining senior and junior debt into a single tranche with a blended interest rate. Unitranche facilities are increasingly being used outside the sponsor-led market, as corporate purchasers seek to take advantage of the flexibility the structure can offer.

Direct lending products may also feature more prominently in the coming year, especially for companies in the cross-over/leveraged bracket. Many credit funds have significant amounts of capital to deploy and as pricing widens in the leveraged debt markets, there is more scope for these funds to compete directly with the banks.

1.2 Corporates and LBOs

Activity during 2020 was significantly affected by the COVID-19 pandemic. Acquisition financing took a back seat during the first half of the year, as many borrowers focussed on their immediate liquidity needs. Debt finance activity was dominated by amendments and waivers, extension requests and short-term loan facilities. To help mitigate the effects of the pandemic, the UK government put in place support initiatives, including the Coronavirus Corporate Financing Facility (CCFF), and the Coronavirus Large Business Interruption Loan Scheme (CLBILS). The government also made temporary and permanent changes to the UK insolvency regime in response to the pandemic in the form of the Corporate Insolvency and Governance Act 2020 (see further **10.1 Jurisdiction-Specific Features**).

During the second half of the year, acquisition financings resumed, both in relation to public M&A deals and private LBOs. Deal volumes increased across all sectors and all deal sizes, with both private equity sponsors and corporate acquirers re-engaging with transactions that stalled as a result of the pandemic or taking advantage of the opportunities for merger and consolidation that have emerged as a result.

For the same reasons, acquisition financing activity is expected to remain buoyant during 2021, alongside a significant amount of refinancing activity, as borrowers re-evaluate financing arrangements from public and private sources, put in place in during the pandemic.

The current areas of focus in the loan market remain the transition from LIBOR to risk-free rates (RFRs) and the development of ESG-linked lending products. These topics are currently impacting almost all loan transactions.

The deadline for the cessation of sterling LIBOR lending has passed and the cessation of LIBOR business in all other currencies will cease by the end of 2021. The bulk of the loan market is transitioning to risk-free rates compounded in arrears, in most cases using the RFR terms in the new Loan Market Association (LMA) recommended forms of facility agreement using RFRs as a reference point.

It has become common for environmental, social and governance (ESG) objectives to feature in facility agreements, in the context of working capital facilities, but also increasingly in event-driven financings. The facility may be structured as a sustainability-linked loan, which links the pricing of a facility to ESG objectives without directing the use of proceeds to those objectives, or a green loan, which restricts the use of proceeds to particular green or social objectives. Approaches to and the use of ESG objectives across the loan market continue to develop. Timetables for ESG-linked transactions can be slightly longer, but there are clear advantages for borrowers; not only may ESG facilities be priced more advantageously but they may also prompt pricing tension in some transactions as a result of the introduction of a differently focussed class of investors.

1.3 COVID-19 Considerations

For a discussion of COVID-19, see **1.2 Corporates and LBOs**.

2. DOCUMENTATION

2.1 Governing Law

See **2.2 Use of LMAs and Other Standard Loans**.

2.2 Use of LMAs or Other Standard Loans

The recommended forms of facility agreement published by the LMA are generally the starting point for English law loan financings.

Corporate acquisition facilities may be based on the terms of the corporate's working capital facilities, 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. The prevalence of term loan B-style facilities in the leveraged market (see further below) has resulted in lending terms moving further from LMA norms.

The terms of investment grade bonds are reasonably standardised. High-yield bond terms are not published by any trade association or body, but market practice has established a framework that is widely used. The European high-yield market is predominantly a New York law market, so bond terms tend broadly to follow the US style. The covenant exceptions and permissions are usually negotiated in some detail.

2.3 Language

There is no legal requirement that an English law governed loan agreement should be written in English, but it is uncommon for an agreement governed by English law to be drafted in a different language.

2.4 Opinions

Legal opinions are typically provided by the legal advisers to the agent and the arrangers for the transaction, and will be a condition precedent to completion. The lenders will generally require that the opinion covers three key areas:

- the capacity and authority of the entities entering into the finance documentation;
- the validity and enforceability of the finance documentation;

- the effectiveness of any security to be granted as part of the transaction.

3. STRUCTURES

3.1 Senior Loans

Structures

The type and complexity of the financing arrangements depend on the purchaser, the target and its business sector. As mentioned above, corporate acquisitions are typically debt-financed using either:

- pre-existing loan facilities, which are capable of being drawn to fund the acquisition, or which can be amended to include an additional acquisition tranche; or
- newly arranged acquisition facilities.

Leveraged acquisitions will typically involve more complex financing structures, comprising different layers of debt. The financing will usually be secured, with the relationship between the creditors regulated by an intercreditor agreement.

Larger transactions are often funded using a combination of loan and bond finance. The acquisition is financed initially with an underwritten bridge loan (to provide certainty of funding, see **9.2 Listed Targets**), which is subsequently replaced with permanent long-term loan finance or (more commonly), refinanced with the proceeds of a capital markets issue. See also **3.3 Bridge Loans**.

Senior Loans

Senior loans often comprise term loan tranches, coupled with a revolving credit (and ancillary) facilities. These facilities will usually be secured and the senior loans will rank in priority to other debt, both contractually pursuant to an intercreditor agreement and/or structurally; for example, junior debt may be lent at holding company level, making it structurally subordinated to the senior loans.

How senior loan facilities are structured in the European leveraged market has evolved quite significantly over the last decade. Historically, senior loans comprised a six-year amortising term loan A, a seven-year term loan B and an eight-year term loan C, alongside working capital facilities. Since the 2008 financial crisis, amortising term debt has become less evident and many senior acquisition facilities comprise a single tranche term loan B (TLB).

TLBs, which originated in the USA, have emerged to become a prominent feature of the European landscape. US-style TLBs are institutionally-led non-amortising term loan facilities. Their defining feature is that they are “covenant-lite” – this means the comprehensive suite of maintenance covenants commonly seen in traditional senior loan facilities (of the kind reflected in the LMA’s leveraged finance documentation), is replaced with a set of incurrence-style covenants, more akin to those seen in a high-yield bond indenture.

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. In addition, the covenants may only apply to a restricted number of key companies in the group, rather than the whole group, known as "restricted subsidiaries" (see **5.1 Types of Security Commonly Used**).

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.

Other advantages of covenant-lite loans for borrowers and sponsors include:

- greater flexibility to run the business without the continuing need for lender consents (and related fees);
- the benefits of a high-yield bond without the public reporting requirements; and
- for issuers who access both the loan and the bond market, the convenience of consistent terms across their debt package.

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 (although there are a range of approaches). 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 always 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. A European TLB may be covenant-lite, but the term TLB may also be used to encompass a "covenant-loose" loan – one containing 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).

The European TLB market continues to grow. TLBs are now the dominant senior lending structure for leveraged lending.

3.2 Mezzanine/PIK Loans

As mentioned above, leveraged acquisitions tend to involve more complicated secured debt structures. The debt finance will typically take the form of senior loans, and may also involve junior (mezzanine/payment-in-kind, PIK) loans, although these structures are not so commonly used since the financial crisis. Second lien facilities tend to emerge when the debt markets are more liquid. These are facilities that rank pari passu with the senior debt in terms of payments, but have a second ranking claim to the senior security package on enforcement.

Subordinated debt can also be accessed via unitranche facilities. Unitranche facilities blend senior and junior debt into a single facility. The facility comprises a single term loan with a blended interest rate, often coupled with a super-senior ranking revolving credit facility. The term loan will be made by funds, while the revolving credit facility is generally made by banks (as non-bank lenders may not be able to provide working capital facilities). The participants in the term loan will agree the ranking of their respective claims and yields between themselves in a separate agreement. As the term loan is priced on a blended basis, interest will usually be higher than traditional bank funding.

3.3 Bridge Loans
Bridge loan facilities are intended to be short-term and are therefore structured to encourage swift refinancing. In practice, bridge facilities tend to be refinanced before they are drawn.

A bridge will generally be available for drawdown for the shortest period sufficient to permit the completion of the acquisition. The period will depend on the nature of the acquisition and, in particular, the length of time needed to obtain any consents or anti-trust clearances that are required. The maximum tenor of an English law bridge facility is generally 24 months, typically comprising an initial term of 12 months, subject to one or two extension options. Extension options (if applicable) are normally exercisable at the option of the borrower (so do not require lender consent), although they are likely to be subject to the borrower's compliance with the representations and undertakings in the loan agreement, the absence of any event of default and the payment of an extension fee.

Bridge loans are popular for larger transactions, which need to access both the loan and debt capital markets. A bridge provides certainty of funding for the purposes of the acquisition, while allowing more time for any long-term debt to be put in place.

3.4 Bonds/High-Yield Bonds
Bonds may be used to finance acquisitions. Bond finance is generally employed in conjunction with an initial bridge loan, which is refinanced out of the proceeds of the bond issue on or after completion of the acquisition. It can be difficult from a timing perspective (although not impossible) to issue a bond to fund an acquisition upfront, which is why a bridge facility is used as a backstop, even though it is never drawn in most cases. See **3.3 Bridge Loans**.

3.5 Private Placements/Loan Notes
Some issuers may use privately placed notes (for example, a US private placement or *schuldschein*) to fund or part-fund acquisitions. As with bonds, above, these products may be used in conjunction with a bridge facility and other forms of debt.

In certain leveraged financing structures, loan notes form part of the equity investment from the sponsors or are used to finance deferred consideration payable to the vendors. The LMA's leveraged documentation contemplates that both investor and/or vendor loan notes may be issued as part of the financing for the acquisition, and that they will be subordinated to the senior liabilities and any high-yield bonds. Investor loan notes may be issued as an alternative to (or in conjunction with) the sponsor's subscription for shares in the holdco company. Vendor loan notes can be used where, for example, the acquisition is subject to an earn-out, allowing the vendors to receive additional consideration at a later date if specified performance objectives are met by the target company (particularly as part of a management buyout).

3.6 Asset-Based Financing
Asset-based financing is a form of senior secured lending, whereby funds are advanced based on the value of certain of the borrower's assets, and can be useful for acquisition financings. While it is a specialised area of lending and will not be suitable for all transactions, in an acquisition context, the target's assets may be used as the borrowing base for the facility, leveraging the performance of the asset class

(instead of EBITDA) to determine the availability of the loan and monitor its performance. While the structure will depend on the nature of the assets involved, asset-based lending can offer an alternative to cash-flow funding, as the interest charged will often be lower (as the facility will be closely linked with the valuation of the secured assets), and there may be fewer and more flexible covenants than a typical secured term loan. The facility will be secured against the relevant asset class, and can be provided on its own or part of a wider debt package.

4. INTERCREDITOR AGREEMENTS

4.1 Typical Elements

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 intercreditor agreement.

The parties to the intercreditor 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 intercreditor agreement published by the Loan Market Association (LMA) are often used as a starting point. However, the LMA templates generally require significant alteration to fit the applicable capital structure, which may be more or less complex than the assumed transactions contemplated by the LMA templates.

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.

Payment of Principal, Interest and Fees

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 the 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.

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 separately to the intercreditor agreement, which will refer back to the restricted payment covenants in the relevant loan and/or bond documentation.

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 intercreditor agreement, a turnover trust or clawback mechanism generally ensures that the prior ranking creditor (or security trustee on his or her behalf) is able to recover the relevant amount from the junior creditor.

4.2 Bank/Bond Deals

As the prevalence of bank/bond deals increased, intercreditor terms (or the range of possibilities) became more standardised, leading the LMA to publish two forms of intercreditor agreement for bank/bond structures: (i) a super-senior revolving credit facility/senior secured notes agreement and (ii) an agreement contemplating super-senior revolving facility/senior secured notes/high-yield notes.

Where the secured debt package comprises a super-senior RCF and senior secured notes, the relationship between the bank debt and notes is typically as follows.

- Scheduled payments of principal and interest are permitted at all times to the RCF lenders and senior secured noteholders (referred to collectively as the “primary creditors”), save for an optional – and reciprocal – payment stop on enforcement. Junior liabilities, comprising intra-group obligations and vendor and equity liabilities, are contractually subordinated and payments are permitted only in accordance with their terms, as discussed above in relation to senior/mezzanine intercreditor structures.
- The RCF lenders (and associated hedge counterparties) rank first in the payment waterfall for the purposes of the proceeds of enforcement of the security package.
- There is no enforcement standstill applicable to the unsecured junior liabilities, save that proceeds of enforcement must be turned over.
- Voting instructions are generally passed on a majority super senior RCF and majority senior secured noteholder basis, save on enforcement where the super-senior RCF lenders' instructions will take priority in limited circumstances (for example, where there is a failure to progress within a specified period).

If high-yield notes are issued in conjunction with the senior secured notes and super-senior RCF, the intercreditor terms will operate slightly differently (it is assumed that the high-yield notes will be both structurally and contractually subordinated), as follows.

- Payments to the RCF lenders and senior secured noteholders typically operate as described above. In regard to the high-yield noteholders, permitted payments are generally subject to similar restrictions as mezzanine lenders, with similar payment stop mechanics. The high-yield noteholders are also subject to an enforcement standstill.
- All parties will typically be secured, although the high-yield noteholders' security is often less extensive, with two layers of security included:
  (a) security granted in favour of the "priority creditors" (ie, the RCF lenders, senior secured noteholders and related hedging counterparties); and
  (b) security granted in favour of all parties by the parent over its shares in the borrower and its rights in relation to intra-group debt (the "common transaction security"), in relation to which the high-yield noteholders will rank behind the other parties.
- Before enforcement, voting is typically carried out on a majority super-senior RCF lender and majority senior secured noteholder basis (as above) with the majority high-yield noteholders taking control of voting only after discharge of the RCF and senior secured notes. On enforcement, the RCF lenders and senior secured noteholders control the process, with the high-yield noteholders granted limited instruction rights on enforcement of the common transaction security.

4.3 Role of Hedge Counterparties

Leveraged transactions may require the borrower to enter into hedging arrangements to mitigate against interest rate and, for some transactions, exchange rate fluctuations. The hedge counterparties will be party to the intercreditor agreement, and rank pari passu with the senior facilities and share in the security package.

Scheduled payments under the hedging will usually be permitted until the seniors enforce or an insolvency event occurs. Generally, close out (enforcement) will only be permitted for payment default (subject to illegality or tax events) or upon senior enforcement (and the senior lenders can force the hedging lenders to close out if they are enforcing).

5. SECURITY

5.1 Types of Security Commonly Used

Investment grade acquisition financings may be guaranteed but may 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 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) subject to agreed exceptions, for example where:

- there are legal impediments to granting security; or
- to grant security 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 will be taken as to 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 (i) restricted subsidiaries and (ii) 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 TLB market.

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; if the assignment complies with the requirements of Section 136 of the Law of Property Act 1925 it will be a legal mortgage, and if it does not, it will be an equitable mortgage.

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; or
- a 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:
  (a) existing or future; or
  (b) 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 certain amounts owing to Her Majesty's Revenue and Customs, HMRC) and, in respect of charges created on or after 15 September 2003, the "prescribed part", a ring-fenced fund, capped currently at GBP800,000, 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. See **5.7 General Principles of Enforcement**.

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.

5.2 Form Requirements

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 forms of security which can be 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.

Registration Requirements
Security created by a company incorporated in England and Wales must be registered to protect the secured creditors. See further **5.6 Other Restrictions**.

5.3 Registration Process
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.

The process for registration is specified by the Companies Act 2006: for charges created by a company registered in England and Wales, a "statement of particulars" (the prescribed forms to be completed are available from Companies House), together with a certified copy of the security instrument must be registered at Companies House. If the security is not created or evidenced by an instrument, a separate form must be completed. Forms can be filed in hard copy or electronically, and a filing fee is payable.

5.4 Restrictions on Upstream Security

See **5.5 Financial Assistance**.

5.5 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 public company formed and registered under the Companies Act 2006, the target and any of its subsidiaries (whether public or private);
- if the target is a private company formed and registered under the Companies Act 2006, any 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.

5.6 Other Restrictions

Other than registration of the security at Companies House (see **5.3 Registration Process**), 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.

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.

5.7 General Principles of Enforcement

Generally speaking, lenders are able to enforce security themselves (or through a security trustee acting on their behalf) without applying to court. The triggers for enforcement will mainly be a matter of contract, and well-drafted security documentation will include detailed provisions relating to the timing and manner of enforcement. Such enforcement rights will usually be extremely broad and permit the lender to undertake a range of actions (such as a power of sale and a right to appoint a receiver). It is more common for lenders/security trustees to appoint a receiver (or, where appropriate, an administrator, discussed below) to enforce the security, rather than enforce it themselves.

If the security document does not include mechanics relating to the enforcement of security, rights are available as a matter of law under the Law of Property Act 1925 and the Insolvency Act 1986. It is common for the contractual rights of enforcement included in security documentation to expressly include (and enhance) all rights available as a matter of law.

If the security includes a floating charge over all or substantially all the security provider's assets (a "qualifying floating charge") the lender will also have important rights in relation to the commencement of administration proceedings under the Insolvency Act 1986 to enforce its security. A qualifying floating chargeholder may:

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

Once a company enters into administration, it will benefit from a moratorium, preventing creditors from enforcing their claims. Administration proceedings allow an administrator to try and rescue a struggling company or achieve a better result for creditors than if the company were wound up (which often means selling the company and distributing the proceeds to those entitled, including the secured creditors). If neither of these objectives are achievable, the administrator will realise the assets to make a distribution to the secured creditors.

6. GUARANTEES

6.1 Types of Guarantees

See **5.1 Types of Security Commonly Used**.

6.2 Restrictions

When considering whether it is appropriate to enter into a guarantee, the directors of the company must consider whether it is in the best interests of the company to give the guarantee. For downstream guarantees, the directors may be able to conclude that borrowing funds under the facility agreement (particularly if it is a condition of the agreement that the parent provides a guarantee) will enable the subsidiary to carry on and enhance its business, thus increasing both its own value and the dividends the parent guarantor will receive.

Upstream guarantees can be more complicated. The analysis will always depend on the facts of each transaction, but relevant factors may include the benefit the guarantor will derive from being a member of a group which will have access to increased liquidity or, if the guarantor is dependent on the borrower for liquidity support or other intra-group services, the benefit derived may be the continuation of those services as a result of the loan being made to the borrower.

Maintenance of capital rules must be complied with, and upstream guarantees may also need to consider financial assistance restrictions (see **5.5 Financial Assistance**). The lenders are likely to require a shareholder resolution to be passed to approve upstream guarantees.

6.3 Requirement for Guarantee Fees

There is no requirement for a guarantee fee to be charged. However, there may be circumstances in which it is appropriate for a fee to be paid, including to help with the corporate benefit analysis discussed above, particularly in relation to upstream or third-party guarantees.

7. LENDER LIABILITY

7.1 Equitable Subordination Rules

See **7.2 Claw-Back Risk**.

7.2 Claw-Back Risk

The "claw-back" rules relating to transactions at an undervalue, preferences and voidable floating charges under the Insolvency Act 1986 may all be relevant in relation to any security granted as part of the financing package for an acquisition.

A transaction entered into by a company incorporated in England and Wales, or any foreign company subject to English insolvency law proceedings, is at risk of being challenged by the insolvency officer if both of the following apply:

- 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 both 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).

8. TAX ISSUES

8.1 Stamp Taxes

The execution of a loan agreement will not, in itself, attract stamp taxes in England and Wales. In any event, the finance documentation for an acquisition will usually seek to protect the lenders against any stamp taxes that might arise; for example, the LMA's recommended forms of agreement, including its template for leveraged acquisition transactions, include an indemnity from the obligors for any stamp taxes, together with a representation that no filing obligations or stamp taxes apply.

Transfers of shares generally attract stamp duty, payable on the consideration for the transfer. If the loan agreement is secured and includes security over shares, however, stamp duty will not be chargeable as a transfer of shares by way of security is exempt from stamp duty as it is deemed (for the purpose of stamp taxes) that there is no consideration payable for the grant of security.

8.2 Withholding Tax/Qualifying Lender Concepts

It is standard for the borrower to be required to gross up interest payments for any tax payable and to indemnify the lenders in respect of certain other tax liabilities relating to the loan agreement. However, there are multiple exemptions from UK withholding tax. It is, therefore, standard practice for borrowers to agree to gross-up (and therefore in practice include in syndicates) only lenders to whom one of these exemptions apply, defined as "qualifying lenders". The borrower's obligation to gross-up lenders in respect of withholding tax liabilities is limited to lenders who are qualifying lenders on the date of the agreement. The result is that the gross-up obligation is triggered only if, after the date of the agreement, there is a change in law that results in the relevant lender losing its qualifying lenders status.

The concept of a qualifying lender is reflected in the LMA's English law documentation for investment grade and leveraged transactions. The concept essentially captures lenders who (on the basis of the UK tax regime in existence at the date of the agreement) can be paid free of withholding tax – allowing the borrower to conduct due diligence on its syndicate at the outset of a transaction that only those lenders to whom withholding tax does not apply are participating in the loan. The risk of paying withholding tax in relation to the primary syndicate should only apply if there is a change in law. Lenders joining the syndicate after primary syndication are typically required to confirm their qualifying lender status.

8.3 Thin-Capitalisation Rules

A company may be thinly capitalised due to either:

- a special relationship between the borrower and the lender; or
- 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, Her Majesty's Revenue & Customs, HMRC (which deals with tax matters in the UK) 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 assumes that borrowing will be on a sustainable basis, so that the business must be able to trade, invest and meet its other obligations as well as servicing the debt.

9. TAKEOVER FINANCE

9.1 Regulated Targets

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 further **9.2 Listed Targets**).

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).

9.2 Listed Targets

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 of the Companies Act to address non-compliance, including the power to impose financial penalties.

Methods of Acquisition

Takeovers of listed companies are structured either as contractual offers or schemes of arrangement.

A contractual offer 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.

A scheme of arrangement is typically 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 it 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, it has every reason to believe that it 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, its 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.

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 publicly available in relation to 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 subsequently conceded 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 – in many cases, this can be too small a window.

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 is unconditionally contracted to acquire both (i) 90% of the shares to which the offer relates and (ii) 90% of the voting rights in the company to which the offer relates.

10. JURISDICTION-SPECIFIC FEATURES

10.1 Other Acquisition Finance Issues

National Security and Investment Bill

The National Security and Investment Act 2021 (the NSIA) introduces a new regime which permits the to review and intervene in business transactions where control of a qualifying entity or asset occurs that might reasonably raise national security concerns. The NSIA is broad in scope, covering both foreign and UK-based acquisitions of companies or assets which have a sufficient nexus with the UK – that is, they have activities in, or supply goods and services to, the UK. There are no minimum thresholds.

Acquisitions which occur within "specified sectors", including energy, transport and communications, will require mandatory notification to the Secretary of State for Business, who also has the power to "call-in" a transaction which does not fall within the mandatory regime but which it is considered poses a risk to national security. This may be exercised, for example, to scrutinise asset acquisitions, which are not subject to mandatory notification, or where a transaction does not fall within the "specified sectors" but the acquirer raises national security risks. In addition, there is a voluntary regime outside of the core "specified sectors" whereby notification should be made if the transaction raises national security considerations. This advance clearance avoids the risk of the transaction being "called-in" at a later date.

The "call-in power" is retrospective for up to five years after the deal completes, but only for six months from the time the government becomes aware. Unusually, the legislation will have retrospective effect, and will apply to transactions that complete between 12 November 2020, and the date of commencement of the Act. Under the mandatory regime, transactions become in-scope upon commencement of the Act and can be "called-in" at any time if not notified. The exception is for transactions completed between 12 November and commencement of the Act, where the Secretary of State for Business has a retrospective "call-in power" for up to five years, or six months from becoming aware of the transaction.

The timing implications for transactions are potentially significant. Following a voluntary notification, the Secretary of State for Business has 30 working days to issue a "call-in notice". Once a "call-in" is made, including for non-pre-notified transactions, there will be a determination as to whether further action is needed within 30 working days, extendable by a further 45 working days. The period can then be extended indefinitely by agreement between the Secretary of State for Business and the investor.

The penalties for completing a transaction without approval include the transaction being declared legally void, up to five years imprisonment and monetary fines (the higher of 5% of global turnover and GBP10 million).

The NSIA was presented to Parliament on 11 November 2020 and received Royal Assent on 29 April 2021. The government has said it expects the NSIA to commence towards the end of 2021.

Reforms to UK Insolvency Laws

The Corporate Insolvency and Governance Act 2020 (the "Act") contains temporary measures which aim to alleviate some of the immediate challenges of COVID-19 and long-term reforms to the restructuring and insolvency regime.

The permanent measures introduced by the Act include the following.

Moratorium procedure

A new moratorium procedure gives eligible companies in financial difficulty time to put together a rescue plan. During the moratorium, a payment holiday for certain types of pre-moratorium liabilities applies and the company is protected against winding-up petitions and most types of legal proceedings. The moratorium also limits creditors' ability to take enforcement action. The company is still required to pay for goods or services supplied during the moratorium.

A key point to note is that debts arising under many financial services contracts are exempt from the payment holiday, which covers lending, securitisation, derivatives and most types of debt capital markets transactions. Not all companies are eligible for the moratorium as there are broad exclusions to the categories of eligible companies (for example, banks are excluded from its scope). The moratorium therefore principally provides protection for corporates against outstanding trade creditor liabilities and landlords.

Restructuring plan

A new restructuring plan procedure, based on (but with significant differences from) the existing scheme of arrangement procedure, enables a company, any creditor or member of the company or a liquidator or administrator to propose an arrangement or compromise to be put to a vote of its creditors and/or members who will be divided into classes, subject to court approval of the class groups and convening of meetings and, ultimately, court sanction of the plan.

A key feature of this new procedure is that the court may sanction a plan that has not been approved by the requisite majority of one or more classes if the judge determines that the dissenting class(es) would be no worse off than in the "relevant alternative", provided at least one class with a genuine economic interest in the alternative has voted in favour of the plan. The restructuring plan therefore has the potential to enable cross-class "cram-up" as well as "cram-down", in contrast to the existing scheme of arrangement which does not allow for cram-down.

Ipso facto clauses

A ban on ipso facto clauses prevents the operation of provisions in supply contracts which allow the supplier to terminate or do any other thing by reason of a company entering certain insolvency procedures. Suppliers can still terminate supply contracts for non-insolvency-related defaults (for example, payment defaults) that occur after the insolvency procedure has commenced. However, termination is banned for defaults occurring prior to the commencement of the insolvency procedure and in respect of which the supplier has not exercised its rights. The ban on ipso facto clauses is limited to contracts for the supply of goods and services.

Most financial contracts (including loans, most debt capital markets transactions, derivatives and securitisations, but again, not unsecured/unguaranteed bonds) are excluded from its scope, as well as contracts where one or both of the contracting parties is in the financial services sector.

Other temporary measures

The Act also introduced temporary measures which were designed to mitigate short-term pressures on companies caused by the pandemic. These measures initially ran until 30 September 2020 but have most recently been extended until 30 June 2021. The changes introduced:

- enact temporary restrictions on the presentation of winding-up petitions (and the making of winding-up orders) in relation to COVID-19; and

- make amendments to the wrongful trading provisions for certain companies. The court may still conclude that directors are liable for wrongful trading but, in assessing the level of financial contribution a director should make to the company's assets as a result, the court must assume that the director is not responsible for any worsening of the company's position, or that of its creditors, for the period from 1 March 2020 to 30 September 2020, or from 26 November 2020 to 30 June 2021.

While the Act does not directly affect the structure of acquisition financing transactions, it will need to be considered when negotiating the debt documentation, in particular in relation to effects of the new moratorium procedure and restructuring plan on the ability to enforce security and the drafting of Events of Default. Both the new moratorium procedure and restructuring plan have already been used (and considered by the English courts), and so this is an area that is likely to develop throughout 2021 and beyond.

Slaughter and May is a leading international law firm recognised throughout the business community for its commercial awareness and commitment to clients. The firm advises on the full range of commercial, financing and other matters. Its financing lawyers are highly regarded for their excellence, broad experience and versatility and have a strong reputation for providing the highest quality of service on the most difficult, demanding and innovative deals, acting for leading UK and international corporates, financial institutions, sovereigns and other organisations. Slaughter and May's acquisition finance practice covers financing for public takeovers, private acquisitions and asset purchases; this work is frequently complex and highly structured, involving sophisticated intercreditor and security-sharing arrangements. The firm's clients in this area include industry buyers, venture capital and private equity funds, other types of equity investors and arrangers and providers of loan finance and capital markets instruments.

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