THOMSON REUTERS
PRACTICAL LAW™

Acquisition Finance in the United States: Overview

by Matthew M. Kelly and Douglas Dolan, Cravath, Swaine & Moore LLP

Status: **Law stated as at 01-Feb-2023** | Jurisdiction: **United States**

This document is published by Practical Law and can be found at: **uk.practicallaw.tr.com/1-625-7215**
Request a free trial and demonstration at: **uk.practicallaw.tr.com/about/freetrial**

A Q&A guide to acquisition finance in the United States.

This Q&A is part of the global guide to acquisition finance. Areas covered include: market overview and methods of acquisition; procedure, finance structure and security; restrictions, including thin capitalisation, regulated and listed targets, pension schemes, lender liability and debt buy-backs; post-acquisition restructurings; and reform.

Market Overview and Methods of Acquisition

Acquisition Finance Market

1. What parties are involved in acquisition finance?

Acquisition finance involves the three primary parties listed below and their respective counsels:

- The buyer.
- The financing sources.
- The seller.

Buyers

A strategic buyer is a non-financial acquirer, most often a company that operates in the same market as or an adjacent market to the target, seeking revenue and cost synergies. The acquisition consideration offered by a strategic buyer may consist of cash, stock, or a mix of cash and stock. A strategic buyer may source any cash consideration by one or more of the following:

- Obtaining new acquisition financing.
- Utilising existing cash on the balance sheet.
- Accessing its existing credit lines.

A financial sponsor seeks to acquire a target as an investment. They are typically private equity firms and pay cash for acquisitions, using acquisition finance to fund a significant portion of the consideration.

Financing Sources

US acquisition finance is arranged by US and international banks, who in turn syndicate the financing, and other non-bank lenders. Since the 2008 financial crisis, US banks have been subject to greater regulatory scrutiny and stricter capital and liquidity requirements. In March 2013, the federal banking regulators released guidance highlighting the risks associated with aggressive leveraged acquisition and buy-out financing structures. The guidance identified issues of concern, including underwriting financing structures that involve excessive leverage, specifically noting concerns over leverage ratios exceeding six times earnings before interest, taxes, depreciation, and amortisation (EBITDA).

These developments have tempered the willingness of US banks to underwrite highly leveraged buy-outs and other aggressive financing structures. In turn, non-bank direct lenders (who are not subject to the above leveraged lending guidance) have become an increasingly significant source of acquisition financing. These trends have accelerated in recent years, as non-bank direct lenders have grown in size and finance an ever-greater share leveraged buy-outs.

Sellers

Sellers, which include public and private targets, are primarily concerned with ensuring that the buyer has obtained sufficient financing commitments (with appropriately limited conditionality) to pay the purchase price and other payments necessary to consummate the transaction.

Methods of Acquisition

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

Share Acquisitions

Share acquisitions are used both in:

- Private acquisitions, which can be directly agreed with the seller's shareholders.
- Public company acquisitions, which can be effected as a tender offer for the target's shares.

Tender offers generally require at least a majority (and, in some cases, a supermajority) of the target's shares to be tendered for the buyer to gain full control of the target by squeezing out any remaining shareholders. A squeeze-out can present challenges for acquisition finance if it cannot be undertaken concurrently with completion. The particular ownership threshold necessary to effect a squeeze-out will depend on the laws of the target's state of incorporation and the terms of the target's charter. Under Delaware law, it is possible (if not prohibited by the target's charter) to effect a squeeze-out after obtaining a simple majority of the target's shares.

Although share acquisitions generally avoid triggering anti-assignment provisions in the target's debt agreements, they often trigger change of control provisions in those debt agreements.

Merger

Mergers are used in private acquisitions and public acquisitions. Subject to certain exceptions, a shareholder of a merging Delaware corporation can demand that a court determines the value of its shares in an appraisal proceeding.

Although reverse-triangular mergers (in which a subsidiary of the acquiror merges with and into the target, with the target becoming a subsidiary of the acquiror) generally avoid triggering anti-assignment provisions in the target's debt agreements, they often trigger change of control provisions in those debt agreements.

Asset/Carve-Out Acquisitions

Asset acquisitions are often used by buyers that seek to limit the liabilities that they assume from the seller or when the business being acquired is not held within a discrete operating company. Asset/carve-out acquisitions can also be used to address tax or regulatory issues. When the acquired business is not held within a discrete operating company, the acquisition can take the form of:

- A transfer of assets and liabilities.
- The acquisition of multiple entities.
- A combination of both.

Asset acquisitions typically involve more legal documentation than share acquisitions or mergers, to address the transfer of separate assets and liabilities. This can include third-party consents to assign contracts, including any debt of the target to be assumed by the buyer. In addition, seller's counsel must be mindful of whether the sale of the relevant assets would constitute the sale of "all or substantially all" of the seller's assets under the applicable governing law and, if so, whether such sale triggers change of control or fundamental change provisions in the seller's existing debt agreements. In addition, in the context of an acquisition financing of an asset/carve-out acquisition, carve-out financial statements of the acquired assets or business will typically be required by the buyer and the buyer's financing sources. In particular, the acquisition agreement and, in the case of a committed financing, the debt commitment letter will typically contain provisions specifying the nature and scope of the carve-out financial statements required.

Procedure, Finance Structure, and Security

Procedure

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

Financing Documents

Buyers and their advisors can run a process to solicit financing proposals from a limited number of potential financing sources, in part to minimise the risk of leaks. Initially, this can involve negotiation of primary economic terms through a high-level financing "grid" prior to the negotiation of long-form commitment documentation. Ultimately, the financing commitment is documented by a heavily negotiated set of letter agreements (commonly referred to as "commitment papers"), which include:

- A commitment letter, containing, among other things, the terms and conditions under which the committed lenders will be required to fund their commitments. It typically includes a detailed term sheet or, for multi-tranche financings, multiple term sheets that will form the basis of the definitive documentation.

- Fee letter(s), setting out:
  - the fees to be earned by the lenders, arrangers, and agent(s); and
  - in syndicated financings, the market flex provisions by which the arrangers can modify the terms of the financing to obtain a successful syndication.

In addition, if the financing structure includes bonds to finance the acquisition (including as a permanent replacement for any committed bridge loan financing), the buyer typically engages the underwriters for that bond issuance through a separate engagement letter at the time the financing commitments are obtained.

While the financing commitments are being negotiated, financing sources and their counsel will conduct due diligence on the target company (and, if appropriate, the buyer) and review the acquisition agreement.

Responsibility for Drafting Documents

Traditionally, lenders' counsel was generally responsible for drafting acquisition financing documents. However, financial sponsors typically insist on their counsel preparing the initial drafts of the commitment papers for prospective lenders to mark up.

For strategic acquisitions, lenders' counsel typically have initial drafting responsibilities, but even that has started to change in recent years, with borrowers' counsel drafting documents for certain corporate deals. Documents are typically based on a precedent transaction selected by the borrower, or, if lenders' counsel is drafting, the lead bank's form documents or an agreed precedent transaction. Documents are customarily governed by New York law.

Stapled Financing

Occasionally, the target's financial advisors will offer stapled financing (that is, a proposed financing package offered to potential bidders during an acquisition). However, this involves risks for the financial advisor and target's board, as shareholders of public targets have successfully argued that inadequate disclosures by the target's financial advisors regarding conflicts of interest arising from stapled financing have compromised the target board's sale process.

Definitive Documents

In between the signing and closing of the acquisition, the respective counsels negotiate the definitive documentation for the financing based on the term sheets (and the flex items, if exercised) and typically an agreed precedent agreement. In addition, other banks not party to the initial commitment may join the commitment papers as committed lenders shortly after signing.

Conditionality

SunGard provisions. The primary feature of acquisition financing (as compared to non-acquisition financing) is limited conditionality of funding. It is now exceedingly rare for a target to agree to an acquisition conditional on the buyer obtaining financing. As a result, the acquisition financing practice has developed SunGard provisions, a set of limited conditionality provisions (named after the first transaction to include them). Generally, these limit the representations tested as conditions precedent for funding to:

- No breach of representations by the target in the acquisition agreement that would allow the buyer to terminate the acquisition agreement.
- No breach of certain specified representations by the buyer that are within the buyer's control, for example, corporate capacity.

In addition, the commitment letter will stipulate that the credit documents cannot prevent funding at the closing of the acquisition if all of the conditions are satisfied, including that actions relating to taking security that cannot be completed with reasonable efforts at closing are to be completed post-closing.

Material adverse effect conditions. The material adverse effect condition in the financing documents is consistent with the corresponding provision in the acquisition agreement.

Other conditions. Other conditions will generally be within the control of the buyer or the target, for example, consummation of the acquisition, delivery of financial statements, and customary closing certificates and opinions.

Completion of marketing or bond offering periods. If the transaction is syndicated, the commitment will usually be made subject to a marketing period prior to closing during which the arranger banks and initial lenders will attempt to syndicate the loans to other lenders (or in the context of a bond offering aimed at replacing any committed bridge loan financing, attempt to complete the bond offering) or an inside date (that is, that the financing must not occur prior to an agreed date, which gives the arranger banks time to complete a syndication).

Acquisition Vehicles

4. What vehicles are typically used in acquisition finance?

Acquisition financings typically involve the buyer incorporating a special purpose vehicle (BidCo) to acquire the target's assets or shares or to merge with the target, with the target typically surviving.

The BidCo or target is usually the borrower entity for the financing, with its immediate parent entity and its subsidiaries (subject to exceptions and limitations) providing guarantees and collateral.

Bond investors often require bonds to be issued by a corporation, and so if the BidCo is a non-corporate entity, for example a limited liability company, the bonds are typically co-issued by a corporation that is a subsidiary of the BidCo. Corporate co-issuers are usually an obligor (that is, a borrower or a guarantor) on all of the acquisition debt.

Acquisitions by corporate buyers, or portfolio companies of financial sponsors, present certain additional complexities in that those entities already have a financing structure in place which may or may not permit the acquisition or the incurrence of additional indebtedness to finance the acquisition. If permitted, the buyer can obtain an incremental commitment within its existing financing documentation or through a separate facility. Many modern credit agreements and indentures contain a limited condition acquisition construct. This provides the buyer and seller comfort that the acquisition will be permitted under the buyer's debt agreements by requiring, at the signing of the acquisition (as opposed to closing), the testing of:

- The accuracy of representations and warranties.
- The absence of defaults.
- The availability of ratio-based covenants.

If an acquisition is not permitted under a buyer's debt agreements, the buyer has the option of obtaining a back-stop commitment in an amount to refinance the buyer's existing debt (in addition to the committed financing to consummate the acquisition itself and the refinancing of the target's debt). The back-stop commitment will fall away if the buyer obtains the necessary amendments and consents from the existing lenders.

Whether the acquiring entity is an existing subsidiary or a newly-formed BidCo, the buyer will ultimately typically seek to integrate the target into its existing business to generate synergies and therefore the target and its subsidiaries will usually become part of the buyer's credit group.

Equity Finance

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

In strategic acquisitions, the shares of a public buyer can be provided to the target's shareholders as part of the consideration offered. Public buyers can also raise proceeds to finance cash consideration for an acquisition by issuing common shares and, less commonly, preferred shares or convertible preferred shares.

Financial sponsors and management teams structure their equity investments with common shares, preferred shares, or convertible preferred equity interests.

Debt Finance

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

Debt Financing Structures

Debt financing structures are tailored to a number of factors including:

- The amount of proceeds required.
- The suitability of the debt products for the target business.
- The leverage and expected credit quality after completion.
- The existing or assumed financing of the buyer or target.
- Refinancing and exit strategies.
- Credit and capital market conditions.

The expected credit rating of the acquisition financing affects its terms as follows:

- **Investment grade debt.** Investment grade debt is rated BBB- or higher by Standard & Poor's (S&P) or Baa3 or higher by Moody's and features in acquisition finance structures for quality strategic buyers. Investment grade debt is generally unsecured and unsubordinated and has minimal covenants and lower interest costs than sub-investment grade debt. Investment grade bonds can have longer maturities than high-yield bonds. An issuer of investment grade bonds typically has the right to redeem the bonds, at its option, at any time prior to maturity by paying a make-whole premium (with the requirement to pay that premium typically falling away one to six months prior to maturity depending on the tenor). Some investment grade bonds require the obligor to offer to purchase the bonds upon a change of control (and the occurrence of a related ratings downgrade below investment grade), but others do not.
- **Sub-investment grade or high-yield debt.** High-yield debt has a lower credit rating than investment grade debt. This type of debt typically features in acquisition finance structures for less creditworthy strategic buyers and financial sponsors because of the high leverage that sponsors seek. High-yield debt can be secured and normally has detailed incurrence covenants (including

covenants restricting dividends and other restricted payments). In the case of loans, it can include one or more maintenance financial covenants, which, in many cases, apply only to the revolving facility and not to term loan facilities. High-yield bonds are typically redeemable during earlier years by paying a make-whole premium and often thereafter at par plus a set premium, which is usually a fraction of an annual coupon. High-yield bonds require the obligor to offer to repurchase the bonds on a change of control at 101% of their face value, but financial sponsors often seek a portability exception that provides that no change of control offer is required if a condition is satisfied, for example, no ratings downgrade or a minimum leverage ratio being met.

In the case of a committed financing that is intended to ultimately be replaced by bonds, the commitment letter typically involves commitments for bridge loans for the amount of required proceeds. The underwriters often endeavour to complete the offerings of debt securities prior to completion of the acquisition so the bridge loans never fund (documentation for the bridge loan is often never drafted). Proceeds of debt securities issued prior to completion of an acquisition are typically held in an escrow account pending completion or redemption if the acquisition is not completed. Investment grade acquirers may negotiate to hold the proceeds in their treasury and for the option, but not obligation, to redeem the securities if the acquisition is not completed. If bridge loans are funded, the lenders strive to have the borrower refinance the loans. Bridge loans typically have an initial maturity of one year. However, if the loans are not refinanced within 12 months, they typically convert into term loans with a longer maturity that can be exchanged for debt securities. In the case of a committed financing consisting of term and revolving loans, the commitment letter will describe the terms of the facilities and definitive documentation will be drafted on the basis of such terms (that is, unlike with a bridge loan, the debt commitments will ultimately form a portion of the permanent capital structure).

The following debt financing structures can be used in US acquisition finance:

- Senior secured debt.
- Senior secured second-lien debt.
- Senior unsecured debt.
- Senior subordinated debt.
- Pay-in-kind (PIK) debt.
- Mezzanine financing.

Each of these structures is discussed below.

Senior secured debt. The senior component of an acquisition financing structure often consists of one or more secured term loan facilities and a secured revolving credit facility for working capital purposes. The structure can include asset-based loans secured by discrete assets, for example, receivables or inventory. The maturity of senior bank debt varies, but a first lien term loan often has a seven-year maturity. The revolving credit facility will typically mature earlier, for example, in five years. Senior secured bank facilities can include financial maintenance covenants. However, these are often limited or removed in 'covenant-lite' financings. Prepaying bank facilities typically involves no premium other than in the case of a repricing transaction or for second-lien facilities.

Senior secured debt securities can form part of the senior component of the financing package. However, secured bonds are less common because of restrictions under the Trust Indenture Act of 1939 and rules requiring additional disclosure if the debt securities are or will be registered with the Securities and Exchange Commission (SEC). These considerations usually lead to secured debt securities being issued on a Rule 144A-for-life basis (that is, the securities are not registered or accompanied by registration rights requiring the issuer to register the securities with the SEC (or exchange the securities for registered securities)). Although senior secured debt securities are usually issued on a *pari passu* basis with bank debt, the debt securities often mature after the primary tranche of bank term debt. Senior secured debt securities typically only have incurrence covenants.

Senior secured second-lien debt. US acquisition finance structures with senior secured debt can include a layer of bank debt or debt securities secured by junior liens (that is, second-lien financings). Second-lien creditors are repaid with the proceeds of collateral after satisfaction of the first-lien creditors' claims. Second-lien debt usually matures after the first-lien debt and has a looser covenant package, with covenants set wider than the covenants for senior secured term loans. An intercreditor agreement between the senior secured creditors and second-lien creditors governs matters relating to the collateral (see Question 7).

Senior unsecured debt. Acquisition finance structures can include senior unsecured debt in addition to, or instead of, secured debt. Senior unsecured debt can consist of bank facilities or debt securities, and the preceding descriptions of covenant packages payable on prepayment in this section broadly apply to senior unsecured debt.

Senior subordinated debt. Senior subordinated debt can be included in a US acquisition financing structure. Senior subordinated debt is typically contractually subordinated to the senior debt. Any guarantees of the senior subordinated debt are also contractually subordinated.

PIK debt. PIK loans or debt securities can be included in an acquisition financing structure for a lower level of cash-pay interest. PIK debt can be structured as pay if you can, which requires a percentage of cash interest to be paid based on a metric (for example, free cash flow for a specified period before the payment date) or pay if you want, which allows the issuer to choose whether or the extent to which each interest payment will be paid in cash or in kind.

Financial sponsors have added PIK debt to the financing structure after completion of the acquisition as part of a recapitalisation to pay dividends. PIK debt in this case is typically issued by a holding company of the obligor of the other debt in the financing structure. This structure excludes the PIK debt from the covenant calculations for the other parts of the capital structure and allows PIK investors to control enforcement in the case of a default. PIK debt typically has similar covenants to high-yield bonds in the capital structure with customary modifications, for example, tighter restrictions on dividends and other restricted payments.

Mezzanine financing. Mezzanine financing, for example, subordinated debt or preferred shares can be included in an acquisition financing structure. If the financing structure includes senior subordinated debt, the subordination provisions for mezzanine financing are usually consistent with, or deeper than, the terms for traditional subordinated debt, and can include standstills on enforcement in addition to payment subordination.

Prior to the 2008 financial crisis, mezzanine financing often included equity kickers. Equity kickers have not featured in larger US acquisition financing structures after the crisis. However, mezzanine financing or preferred shares can be convertible into ordinary shares.

Holders of preferred shares have a claim based on a liquidation preference that is paid after all debt claims and other general liabilities, but prior to distributions to common equity holders. Dividends on preferred shares can often be paid in kind.

Documents

There is no standard form of documents for credit agreements (including credit agreements for bridge loans), for example, the Loan Market Association forms. However, certain market groups, for example, the Loan Syndications and Trading Association and Business Law Section of the American Bar Association have developed model clauses, and many lenders and financial sponsors will maintain their own form documents.

The primary documents for an offering of debt securities are a purchase agreement or an underwriting agreement, an indenture, and notes. There is no standard form documents for these but market groups have prepared model documentation or clauses. Documents are typically based on the lead bank's or its counsel's form documents, or a precedent transaction undertaken by the borrower or financial sponsor.

Intercreditor Arrangements

7. What form do intercreditor arrangements take in your jurisdiction?

Lien-Related Intercreditor Arrangements

Intercreditor agreements are used when multiple classes of creditors hold interests in the same collateral. These are typically structures with second-lien debt where the intercreditor agreement establishes both:

- The priorities between the first-lien and second-lien creditors' claims to the collateral.
- The imitations on the second-lien holders exercising their secured creditor rights.

Intercreditor agreements are also used where two creditor groups each hold primary interests in separate collateral, with each creditor group holding junior security interests in the other's collateral, for example:

- An asset-based loan secured on a first-lien basis by inventory and accounts receivable and certain other assets.
- A term loan secured on a first-lien basis by the remainder of the borrower's assets.

A simple criss-cross intercreditor agreement between these creditor groups typically covers matters, including:

- Priorities of the two creditor groups' security interests.
- Control of enforcement of collateral by the creditor group with the primary security interests until that creditor group's claims are discharged.
- Payment waterfalls for proceeds from enforcement.

Intercreditor agreements are also used where two creditor groups each are secured on a *pari passu* basis by the same collateral, for example, a secured loan facility and secured notes. This type of intercreditor agreement typically provides that the two groups of creditors share in the collateral on a *pari passu* basis, despite the fact that one of the groups is secured on a senior basis as a result of perfecting its security interest first.

Contractual Subordination

Certain intercreditor agreements implement contractual payment subordination, in which one group of creditors will subordinate their right to payment to another group of creditors, subject to negotiated carve-outs and exceptions. In the context of a subordinated bond, the subordination provisions are contained in the indenture and provide that the senior debt creditors are express third-party beneficiaries of those subordination provisions. Contractual subordination is rare in the context of syndicated loans.

Structural Subordination

Structural subordination refers to the fact that creditors of a subsidiary will have a direct claim on the assets of that subsidiary, while creditors of the subsidiary's parent (without a guarantee from the subsidiary) will only have a claim on the residual equity owned by the parent in the subsidiary. That priority is a result of organisational structure and not contract, but is an important concept to take into account.

Payment of Principal

Intercreditor agreements relating to collateral usually do not regulate the payment of principal unless paid with proceeds from the enforcement on that collateral. In these circumstances, one creditor group is repaid in priority to the other, and the other creditor group is required to turnover any such proceeds received.

Contractual subordination provisions typically include payment blocks on the subordinated debt until payment of the senior debt, in the event of either:

- Liquidation, dissolution, or bankruptcy of the borrower.
- A payment default on the senior debt.

Contractual subordination provisions also often allow the senior creditors to issue a payment blockage notice if a default occurs and is continuing in respect of the senior debt that would allow acceleration. The subordinated debt cannot be paid after delivery of a payment blockage notice until the earlier of:

- The senior debt holders consenting to payment.
- The repayment of the senior debt.
- The cessation of the relevant default.
- The passage of a period of time, usually 179 days.

Interest and Fees

Payment of interest and fees is generally treated in the same way as payments of principal in intercreditor agreements relating to collateral (see above, Payment of Principal).

Payments of principal, interest, and fees are generally both blocked under the subordination provisions in contractual subordination intercreditor arrangements. The period that a payment blockage notice remains in effect usually allows the senior debt to block one semi-annual interest coupon payment on the subordinated debt securities. Only one payment blockage notice can typically be issued within a 360-day period, which prevents the senior debt from blocking consecutive semi-annual interest payments.

Security Sharing Arrangements

Intercreditor agreements relating to collateral arise in situations where multiple sets of creditors hold security interests over the same collateral, although they have separate security documents. A negotiated issue is the priority of senior creditors if their security interests are:

- Invalid or unperfected.
- Set aside as a fraudulent conveyance.
- Subjected to equitable subordination.

The first-lien creditors can negotiate for absolute priority so that any proceeds from enforcement of the collateral always flow first to the first-lien creditors, regardless of the status of their security interests. Alternatively, the first-lien and second-lien creditors can agree on relative priority, where the first-lien creditors have priority on enforcement proceeds only to the extent that their security interests are valid and perfected. The second-lien creditors will be entitled to the proceeds if the first-lien creditors' security interests are invalid.

First-lien and second-lien intercreditor agreements typically include a standstill provision, granting the first-lien creditors the exclusive right to enforce the collateral for a specified period from a triggering event. A triggering event is usually either a default of the second-lien debt allowing the second-lien creditors to accelerate their debt or the second-lien creditors actually accelerating. After the standstill period, the second-lien creditors can enforce the collateral, unless the first-lien creditors have commenced and are diligently pursuing enforcement. Any proceeds recovered by the second-lien creditors from enforcement of the collateral must still be turned over to the first-lien creditors until the first-lien obligations have been repaid. To facilitate the first-lien creditors' control over enforcement, second-lien creditors typically waive certain bankruptcy creditor rights and provide their consent to certain actions, including:

- Waiving the right to challenge the first-lien creditors' security interests.
- Consenting to the first-lien creditors allowing debtor-in-possession financing.
- Consenting to cash collateral by the borrower if approved by the first-lien creditors.
- Waiving their rights to seek relief from the automatic stay that arises under US bankruptcy law.

Subordination of Equity/Quasi-Equity

Equity and quasi-equity are not typically subject to subordination in intercreditor agreements.

Secured Lending

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

Extent of Security

The collateral and guarantees that support acquisition finance structures generally depend on the components of the structure and the buyer and target's creditworthiness.

Borrowers often seek to exclude assets for which the process of creating and perfecting a security interest is cumbersome or expensive, or which would create issues for the borrower's business or operations. Borrowers often seek to exclude, among other things:

- Immaterial assets.
- Assets securing other debt.
- Assets that would require the consent of a third party or government approval to grant a security interest over them.
- Assets for which granting a security interest involves taxes or other costs that are not commensurate with the benefit of the security.
- Assets of subsidiaries that are not wholly owned.

Although recent changes to US tax law have in certain circumstances removed negative tax consequences from pledging the assets of, and the stock in, foreign subsidiaries, it is still common to exclude from collateral packages all foreign subsidiaries' assets and the voting stock in all foreign subsidiaries in excess of 65%. However, depending on the transaction and the geography of the business of the borrower, foreign collateral can be included.

Types of Security

Taking security in collateral has two steps:

- The creation of the security interest.
- The perfection of the security interest.

Security interests over personal property and fixtures are generally granted under Article 9 of the Uniform Commercial Code (UCC) adopted in the applicable state, but other laws apply to certain categories of assets. Security interests granted over real property are generally governed by state law.

Shares. A security interest over a corporation's shares can be created under the UCC by a security agreement or pledge agreement. A security interest over certificated shares is typically perfected by possession (delivery of the share certificates and blank stock powers). A security interest over un-certificated shares is sometimes perfected through a control agreement, but more typically is perfected merely through the filing of a financing statement under the UCC.

Inventory. A security interest over inventory is typically created under the UCC by a security agreement and perfected by filing a financing statement.

Bank accounts. A security interest over a bank account is typically created and perfected under the UCC by a depositary account control agreement with the account holder and financial institution.

Claims and receivables. A security interest over receivables is typically created under the UCC by a security agreement and perfected by filing a financing statement.

Intellectual property (IP) rights. A security interest over IP rights is typically created under the UCC by a security agreement and perfected by filing a financing statement. A separate recordation for perfection is also typically made for patents and trademarks with the US Patents and Trademarks Office and for copyrights with the US Copyright Office.

Real property. A security interest in real property can be created by a mortgage, a deed of trust, a leasehold mortgage, leasehold deeds of trust, or assignments of leases, depending on the interests held and the applicable state's laws. A security interest in real property is perfected by a filing with the county in which the property is located.

Movable assets. A security interest in movable assets is usually created under the UCC by a security agreement and perfected by filing a financing statement. Separate or additional state or federal laws apply to certain categories of assets, including:

- Aircraft and related assets, which are subject to the Federal Aviation Act and require filings with the Federal Aviation Authority.
- Motor vehicles, which usually require a recordation on the certificate of title for the vehicle.
- Railroad rolling stock and related assets, which require filings with the Surface Transportation Board.

- Vessels and related assets, which are subject to the Ship Mortgage Act and require filings with the US Coast Guard.

Guarantees

There are generally no restrictions on a US subsidiary guaranteeing the obligations of another group company, for example, ,restrictions on upstream guarantees, financial assistance, corporate benefit tests, or requirements for a guarantee fee. However, fraudulent conveyance and transfer laws may apply. Although recent changes to US tax law have in certain circumstances removed negative tax consequences from the provision of foreign guarantees, it is typical to exclude foreign subsidiaries from any requirement to guarantee a US parent's debt.

Collateral Agents

Collateral agents are often used in the US.

Restrictions

Thin Capitalisation

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

The US has its own thin capitalisation rules. Generally, US borrowers cannot deduct interest in excess of 30% of taxable income before interest and taxes. The relevant rules are often subject to change, however, so it is critical to consult with a US tax advisor for the most up-to-date guidance on the thin capitalisation rules.

Although not typical, additional care should be taken if the financing will be provided by a related party, especially if the related party is foreign. In addition to ordinary transfer pricing concerns, the US has specific rules that limit the use of related entities to avoid withholding taxes, recharacterise related-party debt as equity in certain situations, and deny tax benefits for certain related-party hybrid transactions (for example, financing instruments that are characterised differently for US and foreign purposes).

Financial Assistance

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

Domestic Subsidiaries

There are generally no restrictions on a US subsidiary granting collateral for the obligations of another group company, for example, restrictions on upstream security, financial assistance, or corporate benefit tests. The entity granting the collateral is not required to be an obligor of the debt for which the security is granted. However, fraudulent conveyance and transfer laws and margin regulations may apply.

Foreign Subsidiaries

Tax law has historically limited the provision of guarantees and collateral by controlled foreign corporations to US borrowers. Due to recent tax law changes, guarantees or pledges by foreign subsidiaries of US corporate borrowers may be able avoid negative tax consequences, but it remains market practice to limit foreign guarantees and pledges as relief may not be available in all cases, in particular, in the case of non-corporate borrowers and non-wholly owned subsidiaries.

Regulated and Listed Targets

11. What industries are regulated in your jurisdiction? If the target is a regulated entity, how can this affect an acquisition finance transaction?

Regulated Industries

For certain regulated industries, change of control transactions are governed by federal or state statutes and regulations. Examples of regulated industries are:

- Aerospace.
- Communications.
- Defence.
- Electricity.
- Rail.

This legislation typically provides that the acquisition of a certain percentage of a company's securities is deemed to constitute a change of control and that regulatory approval is required before completion. Federal regulatory statutes requiring approval for a change of control include:

- The Federal Communications Act.
- The Federal Aviation Act.
- The Interstate Commerce Commission Termination Act.
- The Atomic Energy Act.
- The Federal Power Act.

At the state level (among other regulatory schemes), insurance holding company laws govern the acquisition of insurance companies, and there are often specific laws governing circumstances when the target has a liquor license or a firearms license. In addition, transactions involving the acquisition of a US target by a foreign person can be subject to review by the Committee on Foreign Investment (CFIUS), which must determine whether the transaction affects US national security interests.

Effect on Transaction

Regulatory consents can be required as a condition to the acquisition closing. This can prolong the period between signing and the completion of the acquisition. As it relates to financing, the effect is to require a longer commitment period from the lenders which can lead to additional market flex rights or ticking or other fees to compensate for the additional risk. The security and guarantor package may be limited to avoid entities or assets subject to regulation.

12. If the target is listed, how does this affect a transaction?

Specific Regulatory Rules

Many listed US corporations are incorporated in Delaware. Delaware courts have set out heightened duties for the directors of Delaware corporations in change of control transactions. These duties primarily cover the target board's process in the transaction but have affected matters, including disclosure of conflicts for stapled financing and change of control provisions that can entrench directors of the listed target.

Transactions involving listed targets are frequently contested in lawsuits brought by target shareholders who challenge the process undertaken by the target's board in entering into the transaction.

Methods of Acquisition

There are two basic methods of acquiring public companies:

- **One-step merger of target and buyer (or its subsidiary).** These generally require participation of the target's board so are only used in friendly acquisitions. However, a buyer can seize control of a target's board by seeking the election of its own directors in a proxy contest. In a one-step merger, the SEC may review the shareholder proxy and disclosure documents. In addition, the parties must observe the rules on notice periods for shareholder meetings, which usually results in the process taking at least two or three months. An advantage of one-step mergers is that the buyer controls all of the target's shares at completion, which allows the guarantees and security to be provided concurrently with the refinancing of any existing debt of the target.
- **Two-step process of tender offer to acquire the target's shares and back-end merger.** These can be friendly or hostile. Under SEC regulations, the tender offer must be open for at least 20 business days. If all conditions are satisfied or waived by the bidder, the tender offer closes and the bidder must pay for the purchased shares promptly (usually within three business days). The tender offer period can be too short to market the financing and difficulties can arise if the second step cannot be completed promptly. If a financing condition is included in a tender offer, then the tender offer must remain open for at least five business days after its satisfaction or waiver.

Timing, competitive considerations, and other factors are considered in selecting the approach.

Funding

There is no requirement for the bidder to have its funding in place prior to making an offer. However, boards of listed targets rarely commit to an acquisition without the acquirer having committed financing. Market practice is to have a commitment letter from lenders prior to signing a definitive acquisition agreement.

Margin stock issues should be considered in tender offers. US Federal Reserve regulations limit the ability of banks to extend purpose credit that is secured directly or indirectly by margin stock, that is:

- Any registered equity security.
- Any security that has unlisted trading privileges on a US securities exchange.
- Any American depositary receipt traded on a US securities exchange.

A purpose credit is a loan made for the purpose of purchasing or carrying margin stock.

Squeeze-out Procedures

In a two-step transaction, there are generally two ways that the bidder can acquire the shares of any remaining shareholders:

- If the buyer receives sufficient tenders to effect a short-form merger (that is, 90% of the outstanding shares of each class in Delaware), it can effect the merger without the affirmative vote of any other shareholder on the settlement date of the tender offer.
- If the bidder receives less than the shares required for a short-form merger (more than 50% but less than 90% of each class of the target's shares in Delaware), depending on state law, buyers may

need to undertake the same merger process as a one-step process for the remaining shares. However, changes to the Delaware General Corporate Law implemented in 2013 allow two-step transactions to be structured so the back-end merger can be completed at settlement of the tender offer without a shareholder vote if tenders are received for more than 50% of the shares.

During the period to complete the one-step merger, the buyer may not be able to access the target's cash to service the acquisition debt and to have the target or its subsidiaries provide guarantees or grant security to support the acquisition debt. Additionally, change of control provisions in the target's existing debt may have been triggered by settlement of the tender offer and require refinancing before completion of the back-end merger.

Pension Schemes

13. Are there issues of which debt providers must be aware in connection with the target group's or purchaser's pension schemes?

Pension plans in the US are generally regulated under the Employee Retirement Income Security Act of 1974, as amended.

In an asset acquisition, the buyer and seller can negotiate for the seller to retain the plan's assets and liabilities or for the buyer to assume some or all of the plan's assets and liabilities, subject to certain funding rules and other obligations.

In a share acquisition or merger, the buyer generally assumes the assets and liabilities of pension plans sponsored by the target by operation of law.

The funding adequacy of pension plans is often a significant concern during the due diligence process and, in the case of underfunded plans, in the negotiation of the commercial terms of a transaction.

Lender Liability

14. What are the main potential liabilities/risks for debt providers funding an acquisition?

Anti-Tying Act

The anti-tying restrictions in the US Bank Holding Company Act Amendments of 1970 prohibit a bank from making the availability or price of an extension of credit, or any other product or service, conditional on the customer obtaining another product or service from the bank or an affiliate of the bank. An issue that can arise in acquisition finance is whether engaging a bank's broker-dealer affiliate to act as an underwriter for the bond financing is considered tied to the provision of bank loans or bridge loans. This is why the bank commitment letter is separate from any bond engagement letter. In addition, anti-tying does not apply in cases where the bank's customer (that is, the borrower) is a non-US person or where the arrangements are not imposed by the banks.

Tortious Interference

Since the 2008 financial crisis, lenders have been concerned about litigation from sellers alleging contractual interference with the acquisition in circumstances where the financing for the transaction did not materialise. Lenders seek to mitigate this risk by including Xerox provisions in the acquisition agreement, which typically:

- Provide the lenders have no liability to the seller in connection with the acquisition or the financing (and provide lenders with the benefit of any cap on damages and sole and exclusive remedy provisions agreed between the seller and the buyer, for example a reverse break-up fee.
- Set New York courts as the exclusive jurisdiction for claims by the seller against the lenders.
- Waive any right to a jury trial.
- Specify the lenders are third party beneficiaries of the relevant provisions, which cannot be amended without their consent.

Equitable Subordination

The US Bankruptcy Code allows a court to order subordination of a claim to other claims under the principles of equitable subordination. However, these cases against creditors are rare. Equitable subordination is ordered in circumstances where both:

- The claimant committed fraud or other inequitable conduct resulting in harm to other claimants or an unfair advantage.
- The order would not be contrary to the principles of bankruptcy law.

Inequitable conduct is more commonly found in cases involving insiders or fiduciaries because of the duties they owe to the debtor and because they have greater opportunity to harm creditors.

Third party creditors can be treated as insiders if they exercise domination or control over the debtor. The following actions generally do not constitute domination or control:

- Monitoring the debtor's business.
- Calling loans when due.
- Taking steps to collect payment.
- Generally exercising rights specified under the underlying debt document.

However, the following actions can constitute domination or control:

- Exercising voting rights of shares of the debtor (including by a right in a share pledge).
- Directing the day-to-day operations of the company.

If a creditor is not considered an insider, fraud or inequitable conduct is subject to a higher standard of proof and usually requires conduct such as clear violations of laws or bankruptcy court orders, aggressive contractual overreach, or clear misrepresentations to other creditors.

Fraudulent Transfers

Fraudulent transfer actions can arise under state law or the US Bankruptcy Code. The two categories of fraudulent transfer under the US Bankruptcy Code (which are broadly similar to those under state fraudulent transfer law) are:

- Actual fraudulent transfers, which occur when there is actual intent to hinder, delay, or defraud any creditor.
- Constructive fraudulent transfers, which occur when both the borrower does not receive reasonably equivalent value in exchange for a transfer of assets or incurrence of obligations and one of the following conditions exists:
  - the borrower is insolvent at the time of the transfer or became insolvent as a result of the transfer;
  - the borrower is left with unreasonably small capital as a result of the transfer; or
  - the borrower incurred or intended to incur debt beyond its ability to repay.

Fraudulent transfer issues can arise with respect to upstream guarantees of a parent borrowing or cross-stream guarantees of a subsidiary borrowing if the subsidiary is insolvent and it is unclear what value it is receiving in exchange for providing the guarantee. On the other hand, guarantees and pledges by a parent to support borrowing by its subsidiary (that is, downstream credit support) usually do not present fraudulent transfer issues, since it is easier to show that value is being provided to the parent when capital is advanced to its subsidiary.

Fraudulent transfer concerns are also a feature of a typical leveraged buy-out by a newly formed special purpose vehicle, in that the selling equity holders receive acquisition consideration and the target (borrower) incurs significant new debt and grants liens on substantially all of its assets (that is, there is no reasonably equivalent value received by the target in the transaction). For this reason, the solvency of the target is typically a closing condition, with lenders requiring a solvency certificate that often tracks the language of the fraudulent transfer statute.

Debt Buy-Backs

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

US credit agreements usually include mechanisms for the repurchase of loans by the borrower or its affiliates at prices below par value under a modified Dutch auction or with open market purchases (and some credit agreements permit buy-backs of loans without requiring that they be on an open market basis). Repurchases of loans under a credit agreement that do not include these mechanisms are effectively unpermitted, because credit agreements typically contain both:

- Restrictions on the assignment of loans to the borrower or its affiliates.
- Provisions requiring:
  - the pro rata sharing among lenders of amounts received; and
  - that any payments or prepayments of the loans be applied to all lenders on a pro rata basis.

Amending certain provisions can require the consent of all of the lenders, which in practice can make obtaining the necessary consent impossible. A borrower can also always voluntarily prepay a class of loans, which will apply pro rata among the given lenders and loans.

Open market and negotiated purchases of debt securities by the issuer or its affiliates are generally permitted, however, open market or negotiated purchases may constitute a creeping tender offer (that is, the purchases are considered a tender offer that is subject to the US tender offer rules).

The US tender offer rules for debt securities require the tender offer to be open for at least 20 business days and remain open for at least ten business days from announcement of any change in the percentage of the class of securities sought or consideration offered. The tender offer must also remain open for between five and ten business days (depending on the materiality) after announcement of material changes to the tender offer or waiver of material conditions. To encourage holders to tender their securities, debt tender offers are often coupled with a covenant strip, which involves tendering holders consenting to amendments to the underlying indenture to remove protective covenants.

In January 2015, the SEC released guidance that allowed shortening tender offers to five business days for tender offers of non-convertible debt securities by the issuer or a wholly owned subsidiary for cash to all holders for any and all of the applicable debt securities. Abbreviated tender offers must not:

- Involve a covenant strip.
- Be undertaken when a default or an event of default exists under the indenture or any other material credit agreement.
- Be undertaken in anticipation of or in response to a change of control of the issuer or other material transaction.
- Be financed with indebtedness that is senior to the applicable debt securities.

Post-Acquisition Restructurings

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

While restructurings after completion of an acquisition are common as part of the integration of the target with the buyer's business, there are no common or relatively standard post-acquisition restructuring transactions in particular.

Reform

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

There are currently no significant impending reforms or regulatory changes.

Contributor Profiles

Matthew M. Kelly, Partner

Cravath, Swaine & Moore LLP

T +1 212 474 1318

E mkelly@cravath.com

W www.cravath.com

Professional qualifications. New York bar

Areas of practice. Corporate.

Douglas Dolan, Partner

Cravath, Swaine & Moore LLP

T +1 212 474 1310

E ddolan@cravath.com

W www.cravath.com

Professional qualifications. New York bar

Areas of practice. Corporate.