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Acquisition Financing

Philip Spoerlé and Markus Wolf[1]

Introduction

Nurtured by an increase in M&A activity after the covid-19 pandemic, there was a high demand for acquisition financings in the first half of 2022. In the second half of the year, we saw lenders becoming more and more restrictive in granting large quantum debt financings in particular for highly leveraged transactions on the back of rising interest rates and macroeconomic uncertainties. On this basis, many private equity buyers were forced to increase the equity tranche or to approach debt funds to take the junior debt tranche or to provide unitranche financings.

On 19 March 2023, UBS announced it would acquire Credit Suisse by way of an all-share merger in an emergency deal brokered by the Swiss government in order to protect Switzerland as a financial and business centre. The combination of UBS and Credit Suisse creates a leading asset manager in Europe with more than US$5 trillion in total invested assets. The transaction was consummated on 12 June 2023. It remains to be seen how the takeover of

1 Philip Spoerlé is a partner at Niederer Kraft Frey Ltd and Markus Wolf is a partner at Baker McKenzie.

Credit Suisse by UBS will affect the Swiss market for acquisition financings and the Swiss lending market in general. At the time of writing it is still unclear whether the Swiss entities of Credit Suisse and UBS will be combined. If Credit Suisse's Swiss entity were to disappear as a participant in the Swiss market, it is expected that this would lead to a shift towards non-Swiss lenders having a footprint in Switzerland as well as larger cantonal banks.

Traditionally, the main players in the Swiss market offering acquisition finance solutions were the now-combined UBS and Credit Suisse and Zürcher Kantonalbank, which regularly act as lead arrangers or participate in a club deal structure. In the syndication phase, the arrangers often invite smaller cantonal banks or other local banks to participate in the financing. Large-scale financing are frequently placed with an international banking syndicate involving names such as Bank of America, HSBC, Citibank, BNP Paribas, Deutsche Bank and others. Larger acquisition finance transactions often include a capital market element such as the issuance of a high-yield bond that can either be used as a take-out instrument or be issued at the same time as the loan structure is implemented. Super senior and senior structures, where high-yield bonds provide the only term debt in the structure and a super senior revolving credit facility is put in place to provide liquidity, are not frequently seen in the Swiss market.

Transaction structure and documentation

Sources of funds

By their very nature, leveraged acquisition financing arrangements combine an equity and a debt element. The equity element is provided by way of hard equity (share capital, capital contributions) or quasi-equity (such as deeply subordinated shareholder loans).

The structure and the quantum of the debt element mainly depend on the targeted (or accepted) leverage of the target group: in a low or medium leverage scenario, the debt package regularly consists of senior debt that is structured as a term loan facility to finance the purchase price of, and other costs and expenses related to, the acquisition. Traditionally, the term loan facility consists of a non-amortising (bullet) term loan element and an amortising term loan element (the TLA/TLB structure). If the acquisition financing

is combined with a (full or partial) refinancing of the financial indebtedness of the target group, the bidder's existing debt, or if it is required to satisfy the working capital needs at the level of the target group, the financing will be supplemented by a working capital piece that takes the form of a revolving credit facility. Frequently, a portion of the revolving credit facility can be utilised for letters of credit, bank guarantees or overdrafts under ancillary facility arrangements. In a high leverage scenario, further layers of second lien senior or junior debt will be added. Such debt can take the form of mezzanine loan or high-yield bond instruments. Junior debt may also include a payment-in-kind element which provides that there will be no interest payments until the maturity of the principal.

As a pre-condition for the financing, the financing providers usually require evidence that a certain minimum amount of equity or quasi-equity (ie, subordinated shareholder loans) has been injected into the target group or that the target group has a minimum economic equity. Furthermore, sponsors may also be required to provide evidence that the target group has a certain amount of cash or cash equivalents or available credit limits under long-term committed credit facilities in order to demonstrate that the target group has sufficient liquidity to finance its ongoing activities. This may be of particular relevance in structures where the financing package does not include a working capital facility.

Legal framework

Switzerland has not enacted any specific primary legislation covering acquisition finance or leveraged finance transactions. Instead, such transactions are structured within the general legal framework. Applicable legislation for lending transactions includes the Swiss Code of Obligations, which governs the granting of loans and the taking of certain security interest such as security assignments, as well as the Swiss Civil Code, which governs the establishment of share pledges, mortgages and other security. Furthermore, professional lenders are subject to applicable anti-money laundering, know-your-customer and similar regulations. Special rules apply for public takeover offers with respect to companies listed on a Swiss stock exchange (see 'Public takeover bids').

Also, with the exception of consumer credits where special rules apply, lending by foreign banks into Switzerland on a strict cross-border basis does currently not require any licence under Swiss banking laws and is not subject to the supervision of the Swiss Financial Market Supervisory Authority (FINMA). However, certain restrictions may become applicable where security is taken over real estate in Switzerland that is not used for commercial purposes. While the Swiss inbound cross-border regime for financial services is generally liberal, licence and other regulatory requirements may apply if employees of a foreign bank are physically present in Switzerland (eg, because of frequent travel to Switzerland) or if local infrastructure is used. Finally, the granting of loans in Switzerland or to persons in Switzerland for the purpose of financing transactions with financial instruments qualifies as a financial service according to the Swiss Federal Act on Financial Services (FinSA). In certain instances, it may not be entirely clear whether a traditional acquisition finance transaction would also be covered by the FinSA. If this were the case, the relevant lenders would have to comply with the requirements for the provision of financial services under the FinSA, which include code of conduct rules, organisational requirements, the duty to register with a register of client advisers and the duty to affiliate to an ombudsman's office. Whereas this is not an issue for Swiss banks (who fulfil all of these requirements), it may be worth taking a closer look if certain lenders are foreign banks or debt funds.

Documentation

Larger acquisition finance transactions with a value of more than 30 million Swiss francs (or its equivalent) are usually documented on the basis of the Loan Market Association (LMA) recommended forms of facilities agreements for leveraged acquisition finance transactions. Strong borrowers or sponsors may manage to have the transaction documented under the LMA recommended form of investment grade documentation or to push the leveraged documentation more towards the investment grade standard by reducing the number of restrictions and obligations of the borrower and the target group under the finance documents. For smaller transactions and bridge financings, major Swiss banks also frequently use their own standard bilateral facility documentation, supplemented by drafting that caters for the specific acquisition context. Finally, if the syndicate consists only of Swiss banks, the parties

often agree to reduce the complexity of the documentation by eliminating certain elements or optionalities provided for in the LMA's suite of leveraged documents. The relevant facilities agreements are often referred to as 'Swiss LMA Light' facilities agreements in the Swiss market.

At the point in time the acquirer or sponsor has to submit a binding offer for the acquisition, usually a commitment letter for the financing will be in place. This letter is often based on the LMA recommended forms of mandate letter (best efforts or underwritten) or another standard established by the relevant arrangers. Depending on the negotiation power of the acquirer, it may also be possible that the seller accepts a highly confident letter issued by the arranger. In some cases, bids are backed by financing that is already fully documented. Stapled financing arrangements (ie, financing packages that are arranged by sellers and offered to potential purchasers) are rarely seen in the Swiss market.

Acquisition financings that are arranged by Swiss banks or provided by a club of Swiss banks are typically documented under a Swiss law-governed credit facilities agreement. The vast majority of financings that exceed an amount of 20 million Swiss francs (or its equivalent) are documented under an agreement in the English language. The main reason for this is that in such cases the (future) syndicate may also include lenders from non-German-speaking jurisdictions and that the lenders want to avoid having an additional restriction for future transfers of their exposure, which is likely to be the case if the finance documents are in German. Further, the LMA recommended forms in the English language offer widely accepted drafting for standard provisions, which makes negotiations more efficient. However, in cases where the syndicate includes smaller cantonal banks or other local banks or where the borrower has a specific preference for an agreement in the German language, the transaction may also be documented in German.

Incremental (or accordion) facilities and extension options

In the borrower-friendly environment of the past years, documentary features have emerged in the Swiss leveraged finance space that afford borrowers some flexibility regarding the size and the tenor of the financing. The most common features are incremental facilities (also referred to as 'accordion'

facilities because the total commitments will expand if incremental debt is incurred) and extension options.

Under the incremental facility feature, a borrower is given the flexibility to incur, subject to meeting certain pre-agreed parameters, additional credit facility commitments. These will typically benefit from the same guarantee and security package as the existing credit facility commitments. From a borrower's perspective, the advantage of incremental debt is its simplicity: because the incremental feature is pre-baked into the facilities agreement, there is no need to amend the financing documentation. As a result, borrowers benefit from a short execution timetable once the incremental debt has been fully allocated. This makes incremental facilities attractive for the financing of bolt-on acquisitions or capital expenditure.

Extension options provide for a mechanism by which a borrower may effect an extension of the tenor of the financing by pushing out the termination date set out in the facilities agreement. Typically, extension options are uncommitted, meaning that individual lenders may refuse the extension of their commitments. Sometimes, uncommitted extension options are combined with a yank-the-bank feature, pursuant to which the borrower may replace non-extending lenders. Catering to the lenders' internal decision-making procedures required for extending the tenor of financing arrangements and the time required to complete such procedures, facilities agreements usually provide for a particular period prior to the original termination date during which an extension option may be exercised.

Events of default and clean-ups

Swiss-law-governed facilities agreements in acquisition finance transactions typically contain the full (standard) set of events of default as suggested by the LMA recommended forms of facilities agreements for leveraged acquisition finance transactions. In sponsor deals, the sponsor will usually be able to negotiate rather long remedy periods for the failure to comply with general obligations as well as misrepresentations. Furthermore, strong sponsors will usually be granted an equity cure right for breaches of certain financial covenants. The equity cure right requires that a new investment in the form of hard equity or subordinated shareholder loans be made into the borrower group

and such new investment will typically be deemed (and must sometimes be applied) to reduce senior debt, whereas an EBITDA cure is rarely accepted. Furthermore, the possibility to exercise the cure right is usually limited to a certain number of cures during the lifetime of the financing and may not be invoked in two consecutive testing periods.

Besides an equity cure right, Swiss law-governed facilities agreements in the leveraged finance context frequently include a clean-up concept that applies to both the financed acquisition as well as permitted future acquisitions. Clean-up features allow the debtor group to 'bring its house in order' following the relevant acquisition and prevent cross-contamination of 'bought defaults'. Clean-up defaults are often limited to financial covenant breaches, breaches of general obligations under the facilities agreement as well as misrepresentations (in each case other than in relation to sanctions and anti-corruption law covenants). It depends on the specific transaction which clean-up period will be accepted by the lenders. In practice, we typically see a clean-up period that is no longer than 30 days after the closing date for the financed acquisition and 30 days after the consummation of any permitted acquisition.

Security structure and guarantor accession

Types of security

The most common types of security taken in leveraged acquisition finance transactions are the following:

- guarantees by material group companies of the acquirer group and, upon accession, the target and material group companies of the target group;
- pledges over shares in the target company and, depending on the transaction, certain material group companies;
- security assignments of certain trade receivables, insurance claims and intragroup claims;
- assignments of claims or rights under the acquisition agreement and related documents (such as due diligence reports); and
- pledges over bank accounts of the acquirer, the target group or both.

In certain cases, security is taken over real estate, which is typically created by way of a pledge or security transfer of mortgage certificates. Fixed charges or

floating charges are not available under Swiss law. Short-term bridge financings may also be unsecured, which is particularly the case for borrowers with a strong negotiation position and an acquisition that is seen as a strategic fit by the lenders.

The procedures for the establishment of Swiss-law-governed security interests depend on the form of the security and on the type of asset serving as such. As a general rule, the creation of a security interest over movable assets requires possession of those assets to pass from the security provider to the secured parties or a security agent. No security over movable assets can be created by registration into a public register, with the exception of security over ships and aircraft – two assets that define ownership based on a register entry. Owing to the requirement that the security provider must not have exclusive control over the movable asset used as collateral, security packages will only in very rare cases include any transfer for security purposes or pledge of inventory as this may not only lead to a disruption of the daily business of the security provider but also be hardly manageable for the secured parties or the security agent. In respect of security interests over movable assets (other than ships and aircraft), Swiss law generally does not provide for any approval, filing, registration or similar requirements. A special regime applies to security over real estate: while a pledge or security transfer of (paper) mortgage certificates as such does not require any notarisation or registration, the creation of mortgage certificates and any increase of the nominal amount of mortgage certificates need to be notarised and registered in the land register. Finally, it should be noted that although notification is generally not required under Swiss law to create and perfect a security interest, notification may be advisable in order to prevent third parties (such as third-party debtors in the case of an assignment of receivables or the pledge of bank accounts) from being able to validly discharge their obligations by making payment to the security provider.

There is no tax payable on the grant of a security interest, guarantee or a suretyship under Swiss law except for taxes payable in certain cantons for the creation of mortgages. The fees for notarisation and registration (where required) vary from canton to canton. Typically, the value of the mortgage to be created serves as the basis for the calculation of applicable taxes, notarisation and registration costs.

Accession of target subsidiaries

In the acquisition financing context, the finance documentation usually requires an accession of certain material subsidiaries of the target group to the credit facilities agreement in a capacity as guarantor. In addition, such subsidiaries are typically required to provide transaction security in accordance with certain agreed security principles.

With respect to a Swiss subsidiary of a target, there are no specific waiting periods that must be observed before such subsidiary may grant a guarantee or security. That said, the corporate purpose clause contained in the respective guarantor's or security provider's articles of association may need to be amended to expressly permit the granting of upstream or cross-stream guarantees and security, and further adjustments may need to be made (eg, increasing the nominal amount of mortgage certificates). Therefore, Swiss subsidiaries are typically given a certain period of time following closing of the acquisition before they must provide a guarantee or grant security. If the target group also includes non-Swiss subsidiaries that will act as guarantors, security providers or both, the relevant time period for the granting of security and accession to the finance documentation will usually be longer (normally up to 90 or even 120 calendar days following the closing). In addition, if the guarantee or security package is of an upstream or cross-stream nature, the restrictions set out under 'Limitations' will apply. As a general rule, no restrictions will apply if the guarantee or security package is of a downstream nature.

Limitations

Swiss corporate law does not provide for any specific rules on financial assistance and does not provide for any thin capitalisation or similar rules. However, there are capital maintenance provisions protecting the nominal capital as well as the reserves of Swiss corporations. Based on these provisions, a Swiss corporation may not make any payment to its parent company unless such payment is made:

- as a formal dividend;
- in the course of a formal reduction of the relevant company's share capital; or
- on the basis of an agreement that is made on arm's-length terms.

The same applies to any payments to sister companies. No restrictions apply to downstream payments to a wholly owned subsidiary unless the subsidiary is in financial distress.

It is the prevailing view in Switzerland that the granting of a guarantee or security interest to a third party (eg, a lender under an acquisition facility agreement) for obligations of a parent or a sister company as well as certain other acts having a similar effect (such as, eg, an indemnity or a waiver of rights for the benefit of a parent or a sister company), are subject to the same limitations as an actual payment. This ultimately has the effect that the value of any upstream or cross-stream credit support is limited to the amount the security provider could distribute to its shareholders as a dividend at the time payment is demanded under the guarantee or the security interest is enforced. Payments under any upstream or cross-stream credit support may further have certain tax implications. For example, they may trigger Swiss withholding tax at a current rate of 35 per cent in case they do not satisfy the arm's-length test for tax purposes.

Swiss law does not provide for any whitewash or similar measures to avoid the consequences of an upstream or cross-stream guarantee or security. However, it is standard market practice that the following steps be taken in order to mitigate the imperfections of such credit support arrangements: First, the lenders will usually require that the corporate purpose clause contained in the articles of association of any Swiss security provider explicitly permits the granting of upstream or cross-stream security. Additionally, it is typically ensured that the finance documents and the relevant upstream or cross-stream transactions are properly approved by the competent corporate bodies, which includes an approval by the shareholders' meeting of the respective security provider. Finally, the finance documents usually contain limitation language that addresses the free equity limitation.

Contractual subordination

Under Swiss law, there are two types of contractual subordination. First, there are subordination undertakings pursuant to article 725 paragraph 2 of the Swiss Code of Obligations pursuant to which a creditor subordinates its claims for the benefit of all other creditors of a particular debtor. Second, there

are bilateral subordination agreements pursuant to which a creditor subordinates its claims for the benefit of one prior ranking creditor or a group of prior ranking creditors. Subordination arrangements in the context of acquisition finance transactions (eg, in intercreditor agreements between senior lenders and junior lenders, or between primary creditors and intragroup lenders) typically take the form of bilateral subordination agreements.

Subordination undertakings pursuant to article 725 paragraph 2 of the Swiss Code of Obligations should be fully honoured by a liquidator and a bankruptcy administrator as that subordination is disclosed in the debtor's financial accounts. By contrast, bilateral subordination agreements are not reflected in the debtor's financial accounts. Hence, there is a risk that the bilateral subordination will not be honoured by a liquidator or bankruptcy administrator. In order to address this uncertainty, bilateral subordination agreements typically provide that the subordinated creditor assigns its claims in relation to the subordinated debt to the prior ranking creditors. Sometimes, it is stipulated that such assignment will take effect only from the opening of insolvency proceedings over the debtor.

Enforcement

With respect to the enforcement of Swiss-law-governed security interests, it has to be differentiated between private enforcement or realisation proceedings on the one hand and official enforcement proceedings pursuant to Swiss statutory law on the other hand.

If possession of the relevant asset serving as collateral is transferred to the secured parties or a security agent acting on their behalf (which is, eg, the case for a pledge over shares), a private realisation is only permitted if the security provider has consented to this method of enforcement in advance. It is market standard for Swiss-law-governed security agreements to contain such a consent. In case of collateral where legal title to the asset is transferred to the secured parties (which is, eg, the case for an assignment for security purposes of trade receivables, intragroup loans or claims under the acquisition documents), private realisation is the only enforcement method that is available.

In the course of a private realisation, the secured parties (through the security agent) may sell the assets serving as security to a third party or declare to acquire such assets for their own account. Any such transaction must be made for market value. Once the transaction has been effected, the security agent will apply the net proceeds from enforcement towards the discharge of the secured obligations. Any surplus must be turned over to the security provider. The timeline for the enforcement by way of private realisation largely depends on how difficult it is to find a purchaser and to determine the market value of the assets serving as security. For example, if listed shares with a clearly determinable market value serve as collateral, the enforcement may be effected in a couple of days or weeks. By contrast, in the case of shares in privately held companies and, in particular, if the security provider challenges the price applied, the enforcement process may take several months or even years.

If the secured parties choose to enforce by way of official enforcement proceedings, they will have to apply for the commencement of debt collection proceedings with the competent debt collection office. Such proceedings entail multiple stages, some of which require court involvement, and may be rather cumbersome. After the secured parties have progressed through all stages of the debt collection proceedings, the debt collection office will sell the assets serving as collateral in a public auction or, if the security agreement so permits (which is typically the case), by way of a private sale. Once the transaction has been effected, the debt collection office will forward the net enforcement proceeds to the secured parties for application in or towards the discharge of the secured obligations. The debt collection office will pay any surplus directly to the security provider. The enforcement by way of official enforcement proceedings typically takes several months. If the security provider makes use of all the remedies available under the debt collection proceedings, such proceedings may even take several years.

Based on the above, private enforcement will in most circumstances be more favourable for the secured parties than official debt collection proceedings as it is less cumbersome and can be completed rather quickly.

Public takeover bids

Under Swiss law, any public takeover offer requires, among other things, the publication of an offer prospectus. Swiss takeover law provides that the offer prospectus must contain the material information on the financing of the offer as well as confirmation by the independent review body (which is typically a Big Four audit firm) that the bidder has taken all necessary measures to ensure that the funds required for the takeover bid will be available at settlement. In order to have sufficient comfort to issue the required confirmation, the review body usually closely follows the negotiation of the finance documentation (in particular the facility agreement).

According to the Swiss Takeover Board Circular No. 3 (Examination of Public Takeover Offers) dated 26 June 2014 (as amended), the independent review body in particular has to review the creditworthiness of the lender or lenders providing the acquisition financing and those provisions in the finance documentation that enable the lender or lenders to refuse to make available the loan or loans required for the acquisition. As a general rule, such provisions are only permissible if they:

- correspond to a condition in the public takeover offer;
- relate to an essential legal condition with respect to the bidder (such as status, power, authority and change of control);
- relate to the validity of a significant aspect of the acquisition financing (such as the provision of collateral);
- relate to a material breach of contract on the part of the bidder (such as pari passu, negative pledge, merger or non-payment); or
- relate to a significant deterioration of the bidder's ability to pay.

Taxation

Withholding tax

Under Swiss domestic tax laws, there is no withholding tax to be deducted by a Swiss obligor on interest payments to be made under a credit facilities agreement if the 'Swiss non-bank rules' are complied with. These rules provide that:

- the number of finance parties holding a participation or sub-participation in the credit facility that do not qualify as banks in their country of incorporation must not exceed 10 (the 10 non-bank rule); and
- the total number of direct or indirect financial creditors of any Swiss obligor that do not qualify as banks in their country of incorporation must not exceed 20 (the 20 non-bank rule).

A breach of the Swiss non-bank rules may trigger the application of Swiss withholding tax, currently calculated at a rate of 35 per cent. However, if there is an applicable double taxation treaty, the withholding tax may be recoverable by a lender in full or in part.

In addition, interest payments to foreign banks in respect of credits that are secured by mortgages encumbering real estate in Switzerland are in principle subject to a source tax. However, the source tax will, depending on the applicable double taxation treaty, if any, either not be deducted at all, only be deducted at a reduced rate or the amount of the tax will be fully or partially recoverable.

Tax deductibility and thin capitalisation thresholds

As a general rule, interest on debt owed to unrelated parties (eg, bank debt incurred in connection with an acquisition) is fully tax-deductible for Swiss corporate income tax purposes. However, as it is not possible to consolidate the accounts of companies in Switzerland for tax purposes (except for VAT purposes), the purchaser (if it is a Swiss company) may only deduct interest on debt incurred to finance the acquisition from its own earnings and not from the earnings of the acquired company. Furthermore, if the purchaser does not have ordinarily taxable income (eg, a holding company benefiting from participation relief on dividend payments), the deduction of financing costs is not effective from a tax point of view.

By contrast, for tax purposes, the deduction of interest payments on loans from related parties may be limited by the application of the Swiss thin capitalisation rules. According to regulations issued by the Federal Tax Administration, there is a maximum borrowing ratio prescribed for each class of assets. For example, cash or bank accounts can be leveraged by up to 100 per cent of their value, short-term assets by up to 85 per cent of their value, intellectual property by up

to 70 per cent of its value and participations by up to 70 per cent of their value. The aggregate amount of borrowings calculated by applying those borrowing ratios basically corresponds to the maximum aggregate amount of debt that a Swiss company is allowed to have with regard to related parties to remain compliant with the limits permitted by the Federal Tax Administration. When calculating the maximum leverage, the relevant assets may be valued at their fair market value.

If the debts on the balance sheet exceed the limits allowed by the Federal Tax Administration, the excess portion of the debt incurred from related parties is considered hidden equity and interest paid on the excessive portion of the debt might be disallowed as a deductible expense.

The arm's-length principle should be respected in any case where the lender and the borrower are related parties for Swiss tax purposes. In this context it should be mentioned that the Federal Tax Administration publishes safe haven interest rates on an annual basis.

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