CERTAIN KEY ISSUES FOR U.S. PRACTITIONERS STRUCTURING LEVERAGED BUYOUTS IN EUROPE*

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Introduction

This article describes some of the issues we face as U.S. lawyers involved on behalf of U.S. private equity clients in structuring leveraged buyouts in Europe. This article focuses first on issues relating to the structure of the debt financing for an LBO, and then addresses equity investment issues.

In this outline, we describe some of the issues we face as U.S. lawyers involved on behalf of U.S. private equity clients in structuring leveraged buyouts ("LBOs") of companies in Europe. While some of the issues addressed in this outline would arise in LBOs (or other merger or acquisition transactions) in the U.S., the incidence of many of these issues in the European LBO context is greater than in the U.S. market.

As might be expected in a leveraged buyout, debt financing is critical to the transaction. European LBOs present financing structuring challenges that do not normally arise in U.S. LBOs, including the need for structural subordination of layers of debt financing and credit support for the various layers of debt. After we have considered these financing issues, we

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discuss some of the issues that arise in connection with the equity investments that are made in the LBO.

I. DEBT FINANCING

A. In considering the feasibility of an LBO (whether of a public or private company), the buyer must determine a means of financing the transaction and, in many cases, particularly in public to private transactions, demonstrate the availability of financing.[2]

B. Unless the acquisition is relatively small, so that all the debt can be loaned as senior bank debt, it will normally be financed with layers of senior bank debt and mezzanine debt or high yield debt (or both).

C. While there are no fixed definitions of these various types of debt financing, each of them has a typical set of characteristics. Senior bank debt is normally in the form of term loans or revolving credit facilities extended by a commercial lender or syndicate of lenders. Credit agreements for senior bank debt contain numerous restrictive covenants, including covenants prohibiting the borrower from exceeding a specified leverage ratio or incurring indebtedness or paying dividends except as expressly permitted in the agreement. As opposed to high yield debt, which contains "incurrence" covenants, a credit agreement contains "maintenance" covenants. For instance, a default would occur under a borrower's senior bank debt upon its failure to maintain a specified leverage ratio, while a covenant default would only occur under the borrower's high yield debt once it incurred indebtedness after exceeding the applicable leverage (or coverage) ratio.

D. "Mezzanine debt" is a term used to describe a large category of corporate debt that is subordinate to senior bank debt. Mezzanine debt traditionally referred to debt issued to a limited number of sophisticated investors (such as banks, insurance companies and, more recently, investment funds) pursuant to a credit agreement. The credit agreement typically provides the lenders with a second ranking security interest in assets (behind the senior lenders' security interest) and warrants to acquire equity of the borrower.

2 For example, in a cash takeover offer in the United Kingdom, Rule 24.7 of the City Code on Takeovers and Mergers requires a third party (e.g., the offeror's bank or financial advisor) to confirm that resources are available to satisfy full acceptance of the offer. Similar requirements exist in other countries in Europe, which has led to "certain funds" financing commitments from banks at the time of the offer or signing of the transaction agreement, and not only at the time of closing of the transaction. Sellers of private companies are also now seeking these commitments – and LBO sponsors are offering them to enhance their bids for private companies in competitive auctions.

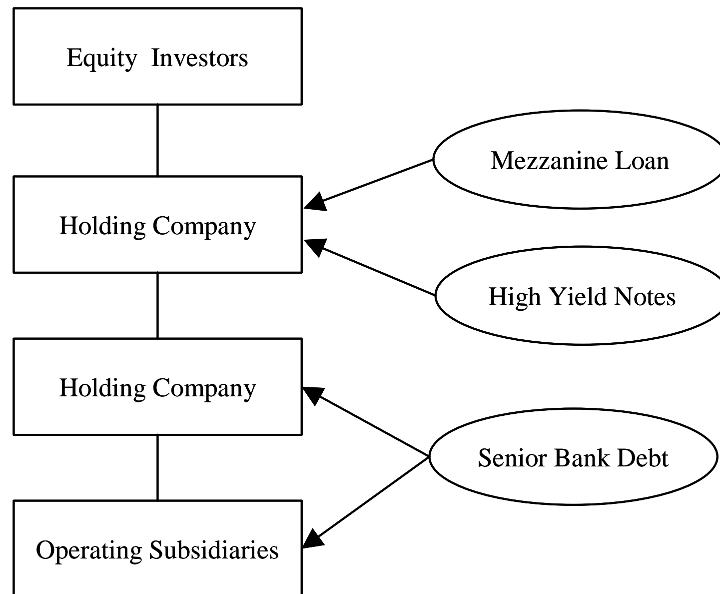
E. Recently, underwriters have offered securities with mezzanine debt characteristics (specifically, a second ranking security interest in assets of the issuer and its subsidiaries) and covenants similar to high yield notes. These "mezzanine notes" can be distinguished from traditional mezzanine financing, which is typically structured more like a senior bank financing than a high yield notes offering.[3]

F. High yield debt is also usually subordinate to senior bank debt. It is typically offered through underwriters to sophisticated investors. The terms of the notes are negotiated by the issuer, the underwriters and their respective counsel prior to being offered and are generally based on market precedent, the strength of the issuer's credit, the amount of senior bank debt or other senior or *pari passu* debt in the issuer's capital structure and general market factors. Unlike traditional "investment grade" debt, high yield notes indentures include numerous issuer and guarantor covenants, including restrictions on the group's (the parent company and, except in limited circumstances, all of its subsidiaries) ability to incur additional debt, pay dividends, make investments, sell assets and engage in transactions with affiliates.

G. In a U.S. LBO, the various types of debt used to finance a transaction are often loaned to a single entity and the "layering" is achieved through contractual provisions in the various debt instruments. In Europe, however, there has been greater uncertainty as to the enforceability of contractual subordination provisions than in the U.S. As a result, in Europe, the layering of the different types of debt is ordinarily achieved structurally. A simplified "layered" borrowing structure is set forth in Figure 1 below.

3 For example, the Focus Wickes debt financing earlier this year combined features of high yield notes (such as the inclusion of incurrence covenants) with features of mezzanine debt instruments (such as second ranking fixed and floating charges over all of the assets that secured borrowings under the senior credit facility) to create a hybrid instrument that was marketed to sophisticated institutional investors.

Figure 1



H. As indicated in Figure 1, the senior lenders make their loans to or receive guarantees from entities that own the underlying business assets. Moreover, the senior lenders' loans and guarantees will often be secured by the underlying business assets or by the shares of subsidiaries that own these assets. The junior lenders typically make their loans to top level holding companies or to finance companies with limited assets and not to operating companies or intermediate holding companies. As a result, the junior lenders' claims are subordinated to the senior lenders' claims on the borrower group's assets, because the junior lenders' source of repayment will be limited to amounts paid to their borrower or guarantors as dividends or distributions on the equity of their subsidiaries, while the senior lenders will have direct claims on the assets of the subsidiaries to repay their loans.

I. In order to enhance their relative credit positions, several types of credit support may be employed in these layered financing structures for the benefit of the senior lenders and the junior lenders. The granting of credit support for the junior lenders often leads to negotiations between the senior lenders and the junior lenders concerning their rights to access their credit support in a default situation.

1. The senior lenders typically benefit from pledges over the shares or assets of the operating companies, and may also lend directly to these

companies. In addition, senior lenders will generally receive guarantees from many (or all) of the subsidiaries of the borrower.

2. High yield and other junior lenders also seek credit support in an effort to improve their position in insolvency proceedings affecting the borrower group and, at least, to ensure their loans do not become further subordinated to the claims of other creditors of the borrower group. This has led to one of the principal recent debt market debates in Europe, which has been seeking to achieve a balance between the interests of the senior lenders and the interests of the junior lenders who obtain credit support.

3. Nearly all of the underwritten offerings of high yield debt securities in Europe in the past twelve months have been structured to benefit from credit support. The most common type of credit support used in these transactions is the receipt of guarantees from subsidiaries of the high yield borrower (or, in the case of a finance subsidiary issuer, guarantees from subsidiaries of the parent company).

4. In addition, intra-group loans among members of the borrower group are featured in many transactions, "creating" assets (in the form of claims on the intra-group borrower's assets) that can be pledged to the lenders to further bolster their overall credit support package.[4]

5. Frequently in the acquisition finance context, some of the borrowers or guarantors of the senior loans are also guarantors of the junior loans. Similarly, the borrowers of intra-group loans may also be borrowers or guarantors of the senior loans. As a result, the senior lenders insist that the guarantees or loans are subordinated to the senior lenders' claims. The terms of the subordination are heavily negotiated between the senior lenders and the junior lenders – the senior lenders view the credit support granted to the junior lenders as an encroachment on the structurally subordinated transaction starting point. On the hand, as indicated above, credit support is now generally required by the high yield market.

6. These inter-creditor negotiations frequently lead to contractual standstill, payment blockage and turnover provisions in favor of the senior lenders, as well as agreements from the junior lenders to subordinate their claims to the claims of the senior lenders.

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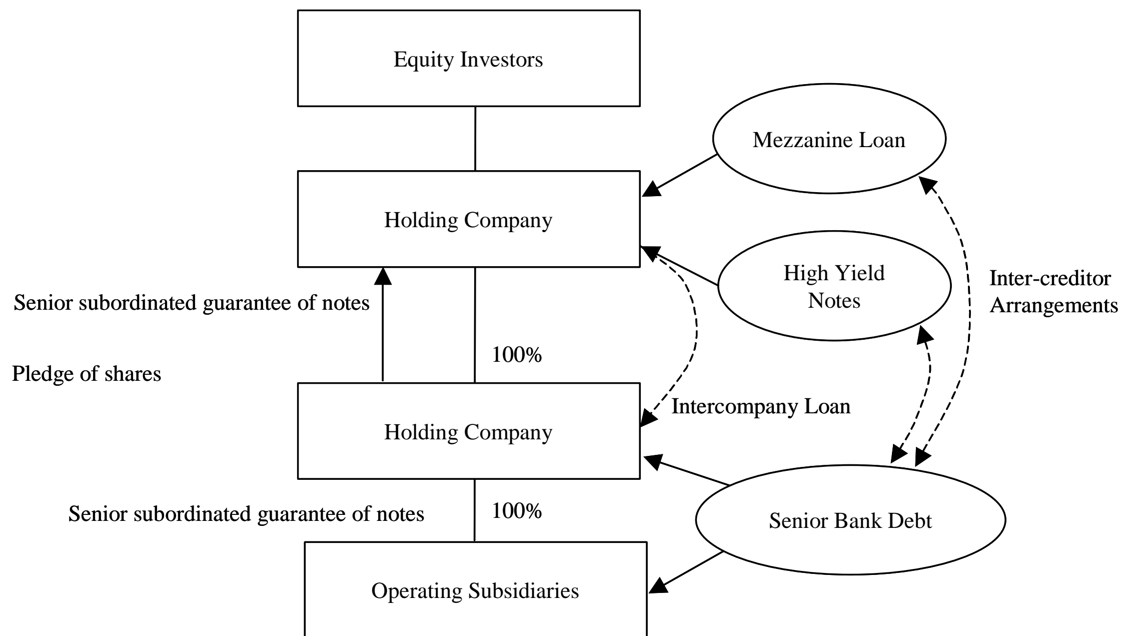
4 These intra-group claims that are pledged may permit the lending company (and, as a result of the pledge, the third party lenders) to achieve parity with the trade creditors in an insolvency or reorganization proceeding in some jurisdictions in Europe.

a). Under a "standstill," the junior lenders agree not to accelerate amounts due on the junior indebtedness or to sue the issuer or guarantors in connection with a default on their debt if an uncured payment default on the senior debt occurs or during a payment blockage period. If payment on the junior securities is subject to a "payment blockage period" and a default occurs under the senior debt, then, upon notice from the senior lenders to the borrower, the borrower is prohibited from making any payment in respect of the junior debt for a specified period of time (usually 179 days).

b). A "turnover" provision ensures that amounts received by the junior lenders in violation of a standstill or payment blockage provision are held in trust and paid over to the senior lenders.

7. Following these negotiations, the simplified structure in Figure 1 may have been transformed into a much more complex structure like the one shown in Figure 2.

Figure 2



J. In Europe, the junior lenders' ability to obtain credit support for their loans may be constrained by local legal requirements, including laws that prohibit the provision of "financial assistance," thin capitalization rules and corporate benefit

rules. In addition, in a transaction that will ultimately be registered with the U.S. Securities and Exchange Commission (the "SEC"), practical considerations relating to financial statement disclosure requirements in the U.S. may limit the junior lenders' ability to obtain credit support.

1. Financial Assistance

    a). Many European countries prohibit the use of a company's assets to support debt used to acquire the company's shares. This prohibition generally applies to guarantees given by subsidiaries of a company being acquired (or by a holding company of such a company) and pledges in respect of the target company's assets, including its ownership interests in its subsidiaries. In addition, guarantees and collateral given in respect of debt used to refinance acquisition debt may be prohibited.

    b). Certain countries are far more restrictive than others in prohibiting financial assistance.

        i. In France, for example, financial assistance rules generally prohibit a company from granting security (including giving a guarantee) for the purchase of its own shares by a third party.

        ii. In Germany, as a general matter, a stock corporation (an *aktiengesellschaft* or *AG*) may not provide collateral in support of debt used to acquire its shares. A limited liability company (*Gesellschaft mit beschränkter Haftung* or *GmbH*), on the other hand, is generally permitted to provide security to a third party, including to secure acquisition debt.

        iii. Financial assistance rules also apply in the United Kingdom, Italy and various other European countries.

2. Thin Capitalization Rules and Corporate Benefit

    a). *Thin Capitalization*. Certain European jurisdictions require companies to maintain adequate levels of capitalization, which may not be put at risk through giving credit support to creditors.

        i. For instance, a GmbH is generally not permitted to provide credit support if the use of its capital in respect of its obligations would reduce its equity below its registered

share capital. Directors of the company can be held jointly liable with the company for a prohibited reduction in equity.

b). Corporate Benefit Rules.

i. To better ensure the enforceability of credit support obligations in certain jurisdictions, a company must determine that its grant of credit support is in the company's best interest. Often, this analysis must be independent of determining whether granting security to a third party is beneficial to the corporate group as a whole.

ii. Corporate benefit rules may be significant factors to consider in countries such as The Netherlands, Belgium and Sweden.

iii. In certain jurisdictions, a subsidiary guarantor must receive a payment from the issuer (or the parent company) in consideration for giving its guarantee.

3. SEC Disclosure Requirements

a). If high yield securities are to be registered with the SEC (usually pursuant to a "back end exchange offer"), it may impact the type of credit support available for the benefit of the holders of the notes. Under Rule 3-10(a) of Regulation S-X, both issuers *and* guarantors of registered securities must include separate financial statements in a registration statement and subsequent SEC reports, regardless of the nature of the securities, the relationship between the entities or whether the guarantee is full and unconditional.

b). There is, however, an exception to this requirement (among other exceptions) when a parent company issues securities guaranteed by one or more of its subsidiaries so long as the subsidiaries are 100% owned by the parent company and the guarantees are "full and unconditional." To the extent that the criteria for the exception to the rule are met, rather than providing separate financial statements for each guarantor, the issuer's financial statements can include a footnote with narrative disclosure explaining the relative impact of the subsidiary group to the financial performance of the corporate group as a whole.

c). When the criteria for the exception cannot be met, either the credit support cannot be made available or the financial statement requirements will apply. The issuer and the underwriter for the high yield notes must decide: is the cost (in terms of interest rate, or even the ability to finance the transaction at all in the U.S. capital markets) of not having the credit support greater than the cost of preparing (on an on-going basis) the required financial statements?

d). Moreover, these financial statement requirements can also affect the inter-creditor arrangements between the senior lenders and the holders of the high yield notes. The SEC considers the inclusion of a "standstill" provision (as described above), as opposed to a payment blockage provision, in the high yield notes as a condition to enforcement of the guarantee. Therefore, in a U.S. registered high yield transaction, the senior lenders may need to make do without a standstill, so the issuer will not need to include guarantor financial statements.

II. EQUITY INVESTMENT

A. As the debt financing structure is developed, the financial sponsor of the LBO must also structure its equity investment, as well as any management equity component. The structure of the equity investment in the transaction will involve a variety of considerations, including tax planning at the time of purchase, during the sponsor's hold period and in connection with various possible exit transactions, and provisions under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). In addition, management's investment in the transaction may be structured in a tax efficient way for the managers, which sometimes requires them to make their investment in a subsidiary of the sponsor's holding company, rather than in the same entity as the sponsor. This investment structure may have important implications for the sponsor's exit planning, and may complicate the documentation for the investment.

B. Tax Planning

1. While there are numerous factors that affect the tax planning for a U.S. sponsor doing an LBO in Europe, a number of issues arise with great frequency. We have set out below some highlights concerning these tax issues.

a). In connection with financing the acquisition, a shareholder loan is often made from the investment funds to the acquisition vehicle

(or a holding company).[5] The loan will generally be subordinated to third-party loans. The terms of such loans typically provide for interest to be capitalized or "paid-in-kind."

b). Unless the loan would be considered equity from the lenders' perspective, the lenders will normally recognize each increase in the principal amount of the loan as income for U.S. tax purposes. Since the lender will not have received a corresponding cash payment for this income, it is called "phantom income" and will require the recipient to use other funds to pay the related income tax. Most sponsors work strenuously to avoid this result. Though complicated, adequate tax planning and coordination with local tax counsel can frequently ensure that shareholder loans are treated as equity investments for U.S. tax purposes for the lenders and debt obligations for local tax law purposes for the borrowers. Accordingly, the increase in the principal amount of the loan would be viewed as an appreciation of the equity investment (and not taxed as interest income).

c). Other tax issues must also be considered in the planning of the investment.

i. For example, during the holding period for the investment, the sponsor may need to consider:

- the potential application of U.S. anti-deferral regimes to the non-U.S. entities in a structure (*e.g.*, "controlled foreign corporation," "passive foreign investment company" and "foreign personal holding company" regimes[6]);

5 In many countries in Europe, interest paid in respect of a shareholder loan is tax deductible by the borrower.

6 Controlled Foreign Corporations. In the event "U.S. Shareholders" own, or are treated as owning under certain attribution rules, more the 50% of the voting power or value of the stock of a foreign corporation, the foreign corporation will be classified as a "controlled foreign corporation" (a "CFC"). "U.S. Shareholders" of a CFC are generally subject to current U.S. tax on certain types of income of the CFC (such as dividends, interest, certain rents and royalties and gain from the sale of property producing such income) and, in certain circumstances, on earnings of the CFC that are invested in U.S. property, regardless of whether distributions are actually made by the company. For these purposes, a "U.S. Shareholder" is a U.S. person that owns, or is treated as owning under certain attribution rules, 10% or more of the voting stock of the CFC. In addition, gain on the sale of the

- whether the structure will give rise to "unrelated business taxable income" for U.S. tax-exempt investors, if any, in the sponsor fund;

- the potential for achieving a step-up in the basis of a target group's assets;

- the impact of local income taxes on earnings in the group; and

- any local withholding tax on the current repatriation of earnings, if this is contemplated in the transaction.

ii. The sponsor may also need to consider its potential sale of, or other exit from, the investment, including the following, some of which may be more relevant in the event of a partial sale or exit from the transaction:

- the imposition of local capital gains tax;

CFC's stock by a U.S. Shareholder (during the period that the corporation is a CFC and thereafter for a five-year period) would be classified in whole or in part as ordinary income.

Foreign Personal Holding Companies. If five or fewer U.S. individuals own, or are treated as owning under certain attribution rules, in the aggregate more than 50% of the voting power or value of the stock of a foreign corporation and at least 60% (50% in certain circumstances) of the "gross income" of such corporation is made up of passive income (for example, dividends, interest, and gain from the sale of stock or securities), then the corporation will be treated as a "foreign personal holding company" ("FPHC"). In this case, U.S. persons that own shares in an FPHC (regardless of the size of their shareholding) would generally be subject to current U.S. tax on their share of the FPHC's undistributed foreign personal holding company income for the taxable year or part thereof. Where a foreign corporation is both a CFC and an FPHC, amounts currently included in income under the CFC rules are not also included under the FPHC rules.

Passive Foreign Investment Companies. A "passive foreign investment company" ("PFIC") is defined as any foreign corporation if either (i) 75% or more of its gross income for the taxable year is "passive income" or (ii) 50% or more of its assets (by value) produce "passive income" (for example, dividends, interest and gain from the sale of stock or securities). There are no minimum stock ownership requirements for PFICs. When a shareholder realizes gain on disposition of stock of a PFIC or receives an "excess distribution" from the PFIC, the gain or "excess distribution" is treated as though realized ratably over the holding period for the PFIC, and taxed as ordinary income. Furthermore, an interest charge is imposed on the U.S. holder based on the deemed tax deferral from prior years to which the income has been ratably allocated.

- any local withholding tax on repatriation of earnings;
- the potential adverse impact of U.S. anti-deferral regimes; and
- the potential application of the "outbound transfer rules" contained in Section 367 of the U.S. Internal Revenue Code.

C. ERISA

1. The investors in the private equity funds investing in LBOs often include employee benefit plans subject to ERISA. In order to avoid the underlying assets of the investment funds being deemed to constitute ERISA "plan assets" of those ERISA investors and the application of ERISA to the transactions engaged in by the private equity funds,[7] each fund which includes investments from employee benefit plans is required to qualify as a "venture capital operating company", or "VCOC," under the United States Department of Labor Plan Asset Regulations.

2. One of the principal requirements for qualification as a VCOC is that, as of the first date on which the VCOC makes an investment and for at least one day during a specified testing period, at least 50% of the assets of the fund, valued at cost, be invested in "operating companies"[8] as to which the fund has "operating management rights." "Operating management rights" may take the form of the right to appoint one or more members of the operating company's board of directors or, alternatively, contractual rights to a combination of information and consultation rights.

7 If the assets of the VCOC fund were deemed to be "plan assets" of employee benefit plans whose assets were invested in the VCOC fund, among other things, (i) the general partners of the VCOC fund could be deemed to be ERISA fiduciaries with respect to such employee benefit plans, (ii) the prudence and other fiduciary standards of ERISA (which imposes liability on fiduciaries) would be applicable to investments made by the VCOC fund, which could materially affect the operations of the VCOC fund and (iii) certain transactions that the VCOC fund enters into in the ordinary course of its business and operation might constitute "prohibited transactions" under ERISA and the U.S. Internal Revenue Code.

8 An operating company is an entity that is primarily engaged, directly or through a majority owned subsidiary or subsidiaries, in the production or sale of a product or service, other than the investment of capital.

3. Compliance with the VCOC requirements is not usually difficult when one sponsor is making the investment. In transactions involving a consortium of sponsors or other equity investors, compliance may be more difficult.

   a). For example, if the investment involves the acquisition of a minority interest in a company, the VCOC requirements would require a VCOC fund to invest directly in the company, and not through a single vehicle with the other investors. Moreover, the company in which the investment is made would need to provide operating management rights directly to that sponsor entity – which may be difficult to obtain from the company in the case of a minority investment.

   b). For similar reasons, the VCOC requirements can affect a shareholder loan structure (described above under Tax Planning). In some transactions, a shareholder loan is made to a subsidiary of the top holding company and not directly to the top holding company, because the subsidiary can better use the interest deductions to shelter its or its subsidiaries' operating income. If the shareholder loan represented a majority of the sponsors' investment, then the subsidiary may need to grant the VCOC fund "operating management rights."

D. Management Equity

1. In many LBOs, the sponsor will want management to invest alongside the sponsor in the equity of the acquired group. In Europe, the sponsor's investment may be made through an entity organized in a different jurisdiction from the jurisdiction in which the management team would want to invest in order for management to achieve favorable tax treatment for their investment. Structuring management's investment in this way, while it may be favorable to the management's tax position, raises several complications.

   a). The sponsor will usually want management to bear the same risks and benefit from the same rewards from the equity investment as the sponsors.

      i. If the management investment is made in an entity that is structurally senior to a portion of the debt financing, then the sponsor will normally want to develop a structure to ensure that management's investment is nevertheless subordinate to the debt financing.

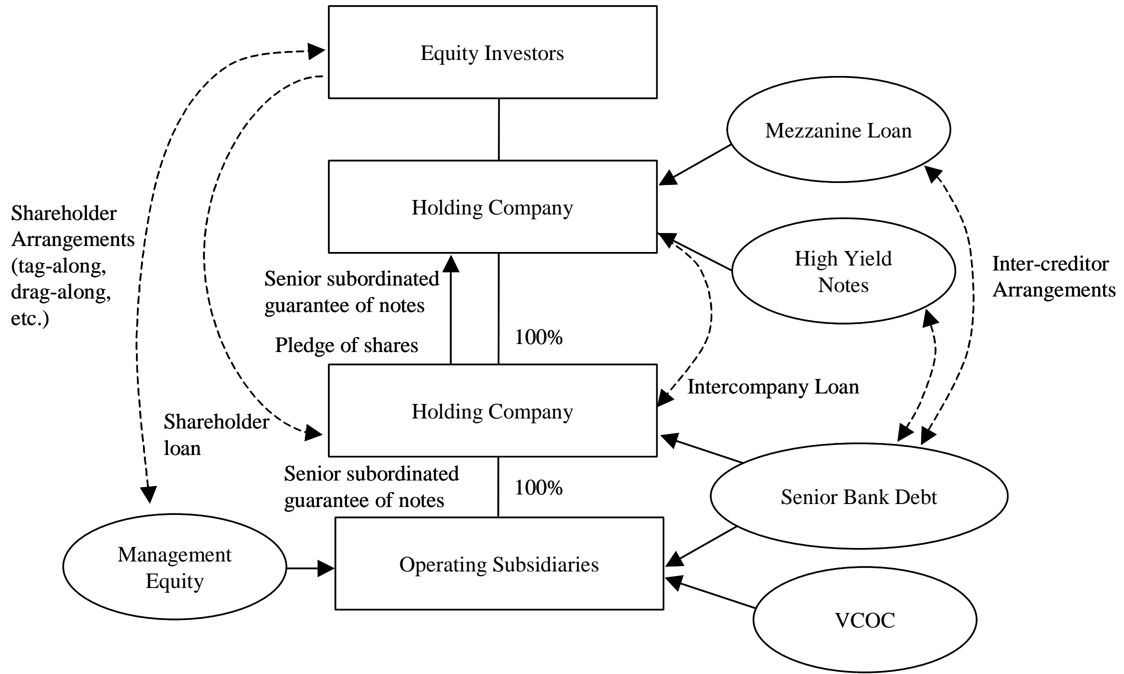
ii. Similarly, if a shareholder loan or preferred shares are used to enable the sponsor to earn a fixed yield on a portion of its invested capital before the common equity is paid, then the management investment may need to be subordinated to this yield, even though the management investment may also be made in a structurally senior entity.

b). Also, the sponsor may want to ensure that management's and the sponsor's sale of the investment is coordinated, so management cannot sell out of the deal before the sponsor. While various mechanics have been developed to achieve this result (such as tag-along rights on sales by the sponsor and "piggyback" registration rights, both of which permit management to sell a portion of their investment alongside the sponsor, but not usually in a proportionate amount larger than the sponsor), when the sponsor's and management's investments are held in different entities in the structure, achieving this result can be challenging.

III. CONCLUSION

In this outline, we have highlighted a number of the key issues that arise in structuring a European LBO for a U.S. private equity sponsor. It should be apparent that the debt financing and the equity investment for an LBO transaction need to be carefully coordinated. After structuring the transaction taking into account the various issues and considerations highlighted in this outline, the LBO structure may look something like Figure 3.

Figure 3



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