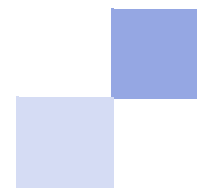


Certain funds acquisitions in the UK

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You are looking to make your first venture into UK public M&A. The target is a quoted UK corporate. As a large corporate yourself, or sophisticated offshore fund, you consider yourself well attuned to the M&A process: you've done your desktop diligence and are ready for the next stage. Then one of your newly-appointed UK advisers mentions the need for "certain funds". What does this mean? Why is it required? Is it something that you and your financiers can deliver – and are they likely to charge extra to do so?

This chapter addresses these questions and goes on to explain the process involved in establishing that certain funds are available, as well as examining some of the key clauses in the financing documentation. In particular, we focus on:

- The background to the certain funds requirement.
- The regulations behind the certain funds doctrine.
- How to meet the standard set by the certain funds regime.
- The implications of using different sources of finance.
- The use of certain funds in private M&A deals.

BACKGROUND TO THE CERTAIN FUNDS REQUIREMENT

In the UK, bids for UK incorporated public companies are governed by the City Code on Takeovers and Mergers (City Code). The City Code is policed by a non-governmental organisation, staffed largely by secondees from market participants, known as the Takeover Panel (Panel).

The Panel sets out to ensure a level playing field for target shareholders and to avoid unnecessary market disruption. The effect that announcing a bid can have on a target's share price is obvious and a key objective of the Panel in policing public bids is to ensure that target shareholders are given enough information at the appropriate time to be able to react to market developments. The requirement, under the certain funds doctrine, for a bidder to have the means to finance an acquisition before it publicly announces its launch is one aspect of the Panel's remit.

Historically, the certain funds doctrine has been largely a feature only of UK public bids. However, Directive 2004/25/EC on takeover bids (Takeover Directive) now incorporates a specific principle which is based on the UK's General Principle 3 (*see below, General Principle 3 of the City Code (GP3)*). It remains to be seen to what extent other member states build on this principle when they adopt their own implementing measures.

It is worth mentioning that it is possible to make a pre-conditional offer (that is, announce that an offer will be made if certain pre-conditions are satisfied) without certain funds being online. Pre-conditional offers are also the subject of Panel oversight and are most commonly used where there is a major regulatory clearance associated with the offer, receipt of which would not usually be possible within the City Code timetable. In view of the inconvenience and cost of committing finance while the satisfaction of the clearance pre-condition is awaited, the Panel has allowed the pre-conditions to extend to the arrangement of offer funding – but within rigid parameters: the financing must come online within 21 days of satisfaction of the pre-condition and written comfort must be provided directly to the Panel that this time frame is likely to be hit.

CERTAIN FUNDS – THE CITY CODE PROVISIONS

The Panel operates on the basis of a number of general principles and specific rules which give rise to the certain funds doctrine:

- **General Principle 3 of the City Code (GP3).** This states that a bid should "be made only when the offeror has every reason to believe that it can and will continue to be able to implement the offer". It goes on: "responsibility in this connection also rests on the financial adviser to the offeror". It is proposed that GP3 will be shortly amended to conform to the Takeover Directive, and will instead read: "An offeror must announce a bid only after ensuring that he/she can fulfil in full any cash consideration if such is offered, and taking all reasonable measures to secure the implementation of any other type of consideration".
- **Rule 24.7 of the City Code.** This Rule underpins the certain funds principle and provides that "when the offer is for cash or includes an element of cash, the offer document must include confirmation by an appropriate third party (e.g. the offeror's bank or financial adviser) that resources are available to the offeror sufficient to satisfy full acceptance of the offer. (The party confirming that resources are available will not be expected to produce the cash itself if, in giving the confirmation, it acted responsibly and took all reasonable steps to assure itself that the cash was available.)" (*For a discussion on the meaning of "full acceptance" see below, What does full acceptance mean?*) It is not proposed that this rule will be amended as a result of the Takeover Directive.
- **The Panel's attitude to conditions.** It is customary for bidders to list a host of conditions to the offer which are linked to the condition of the target's (and the bidder's) business.

However, it is only in extremely rare cases that the Panel will allow such conditions to be invoked. There are in fact no examples of a material adverse change in the target's businesses being permitted as grounds for unilateral invocation of a condition. The relevant circumstances or event would have to strike at the heart of the purpose of the offer before invocation were permitted by the Panel. In any event, other than for pre-conditional offers, financing conditions are not normally permitted by the Panel to be put in place, let alone invoked.

The certain funds requirement is equally applicable whether the bid is made by way of tender offer or the statutory court-governed scheme of arrangement.

HOW TO MEET THE STANDARD – AND WHEN

Unlike in a typical private M&A deal, the certain funds regime for public bids means that it is the financial adviser to the offeror who must be persuaded of adequate funds being available, rather than the seller.

Given that the City Code puts responsibility also with the financial adviser to the offeror, the financial adviser will conduct its own due diligence (and invariably take legal advice) before committing to the cash confirmation in the offer document. A cash confirmation is not an absolute guarantee of funds being available – the financial adviser just has to take reasonable care in reaching its conclusion that resources are duly available – but there is precedent for the financial adviser being called on to provide the funds in extreme cases.

The financial adviser will be looking for an irrevocable commitment to provide or source the relevant financing; heads of terms or commitment letters will not be sufficient. In practice, it will be necessary not only to have signed documentation under which sufficient amounts can be called on, but also to have met all conditions precedent to drawdown (save those purely in the offeror's control) and to have agreed the form of all principal ancillary (for example, security) documents.

Unless the offer is a mandatory cash offer under Rule 9 of the City Code, the cash confirmation does not currently need to be given in the initial press announcement of the formal offer but instead in the offer document. However, given the requirements of GP3 and the fact that the issue of the offer document is required under the City Code within 28 days of formal announcement of the offer, in practice the necessary due diligence must take place and documentation be finalised before the press announcement is published. In any event, the City Code is likely to change shortly to align all bids so that a cash confirmation is given in the formal bid announcement. Note that the formal announcement should be distinguished from a "talks" announcement (usually made in response to market rumour), which would not constitute a firm intention to make the offer and therefore not require a cash confirmation or start the 28-day timetable.

What does "full acceptance" mean?

In practice, the requirement that there is financing for "full acceptance" (see above, Rule 24.7 of the City Code) of the offer means that the finance package or available resources must encompass:

- The maximum amount of cash required as part of any cash element of the basic offer consideration.
- The maximum amount of cash required as part of any cash alternatives to a share exchange offer.
- Any additional target shares which may have to be acquired as a result of the exercise of conversion rights, warrants or options.
- Any parallel cash offers which the City Code may require to be made in respect of other classes of target securities.
- The cash element of any consideration required to squeeze out the non-assenting minority under the compulsory acquisition procedures in the Companies Act 1985.

On the basis that a financing condition would not be permitted, a statement of intention by an offeror to also put in place a working capital facility to the target need not be subject of a certain funds analysis. Note, however, that the Panel would be unlikely to let an offeror lapse its offer if this facility subsequently transpired to be unavailable.

SOURCES OF FINANCE

The financial adviser and its own advisers will at an early stage wish to examine the different sources of finance for the offer. These could be from:

- Existing cash.
- An existing debt facility.
- A new debt facility.
- Equity finance.

These are examined in turn below.

Using existing cash resources

It is unlikely that any sizable cash offer will be able to be sourced from existing cash resources – more commonly, the financial adviser's focus will be to review available cash in conjunction with other sources of finance. Inevitably, the comfort level of the financial adviser (and therefore the detail to which its diligence will be run) will depend on the relationship in existence between the financial adviser and the offeror, the offeror's financial standing and the relative size of the offer to the asset base of the offeror.

The financial adviser will often require comfort that the cash is ring-fenced, for example being placed in an escrow account, the release conditions of which are aligned to funding the offer - or even being deposited with the financial adviser.

Using an existing general purpose facility

Given that certain funds facilities tend to be more expensive than general purpose facilities, it is very unlikely that any trade buyer would have funds available on terms which easily fit with the certain funds doctrine. This is even more unlikely where the debt finance is sourced from a bank or syndicate of lenders operating

outside of the UK. The offeror's financial adviser will therefore need to examine how best to fill any gap in deliverability terms in order to frame its cash confirmation.

Again, the depth of analysis required by the financial adviser will be based on a number of factors and its existing knowledge of the offeror, but there is a sliding scale of potential comfort which it could insist on. In ascending order of rigour:

- Written confirmation from the borrower of available funds.
- Confirmation from a bank that the requisite amounts are available from it for drawdown under the relevant facility, coupled with borrower representations as to no known likelihood of drawstops or acceleration of repayment.
- Drawdown to a ring-fenced account or confirmation from a bank that a deposit of the relevant amounts will be made to the order of the financial adviser.
- Irrevocable letters of credit.
- Cash on deposit in the name of the financial adviser with irrevocable instructions as to its use.

The financial adviser will pay close attention under any of the above options to the terms and conditions attached to drawdown and, particularly in relation to multinational facilities, will need to be mindful of external factors that could restrict drawdown – such as local law capital adequacy requirements or insolvency risks.

Using a bespoke acquisition finance facility

The City Code does not stipulate terms for financing documentation. It is therefore incumbent on the offeror's financial adviser and its lawyers to review the terms of any bid facility to confirm that it contains appropriate terms. Given the need to, effectively, have full documentation to underpin any cash confirmation statement, the offeror should appreciate early in the process that certain funds documentation is likely to lead to a commitment fee being incurred upfront. This can be particularly galling in the case of a hostile bid, where there may be no comfort of a later target board recommendation and limited comfort in advance from target shareholders that the bid will succeed.

In terms of the finance documentation, the starting point will be a typical acquisition finance facility. However, to meet the certain funds requirement there will be a number of features particular to the regime, principally:

- A "certain funds period" from signing until the latest conceivable date on which acceptances might be received in respect of the offer or a squeeze-out of the minority must be funded (allowing for possible timetable extensions). Within the certain funds period, the opportunities for the bank to decline to lend or to accelerate repayment of loans must be heavily circumscribed.
- The bank will often require specified shorter periods within which certain events must occur. A prime example is the level at which the offeror decides it will deem the acceptance condition to be satisfied. The offer terms almost invariably

ably set this at 90% or such lower level as the offeror determines (save on a mandatory Rule 9 bid in which case it can only be set at just over 50%). Frequently, banks require acceptances in relation to 90% of the shares to be obtained within four months of posting the offer document so as to be comfortable that the offeror can put the statutory minority squeeze-out procedures in effect (the four-month provision is subject to change, as a new law in this area is likely during 2007). Depending on the offeror's bargaining power, a lower level of ownership (75%) is sometimes entertained. However, banks will be looking for this comfort so as to be confident that security over the target group can be granted to the banks – and a 90% level provides more certainty than 75%.

- The use of the facility should be broad enough to cover the minority squeeze-out and also the funding of any market purchases of target shares which may be made in furtherance of the offer.
- The circumstances in which the bank can decline to lend are drastically reduced from the normal position, with the normal conditions that all representations have to be correct and no event of default or potential event of default has occurred not being permitted. Although this is a matter for negotiation, grounds for refusal to lend are likely to be limited to illegality, incapacity and insolvency (with respect to the borrower, not the target).

Note in particular that breach of a material adverse change (MAC) covenant in relation to the borrower or the target would not be acceptable grounds for a drawstop: the bank's remedy for breach of a MAC covenant is not to withhold funds but instead to accelerate repayment of the facility, or increase the margin, after the target shareholders have been paid their offer consideration – even if this risks a "fire sale" (where assets are likely to be sold for a considerably lower price than they would have been as a result of a normal negotiation) by the offeror after the event.

- Conditions to drawdown should usually be limited to procedural conditions wholly within the offeror's control.

It is worth noting that the Panel wishes, in the interests of preserving secrecy, to be consulted prior to a wide group of potential financiers being approached to finance a bid. In practice, this usually means that lending banks should not seek to syndicate the facility until after the offer is announced.

Overseas bidders quite often channel financing through a UK incorporated bidder subsidiary in order to reduce borrowing costs by seeking relief against corporation tax on the target's UK profit. If the loan is made to a new vehicle, the obligations of which are guaranteed by its parent, the financial adviser's due diligence is likely therefore to go further than examining the terms of the new company's facility and extend to an analysis of the parent's ability to service such a guarantee.

Using equity finance

No cash confirmation is required in relation to a share exchange offer or a cash alternative which is fully underwritten by reputable underwriters – realistically only an option for a quoted trade buyer. With respect to any underwriting of a cash alternative

(sometimes known as cash underpinning), the offeror must ensure that the only conditions relating to the issue and payment for any securities issued to fund the cash element of the offer are those necessary for their valid issue (for example, the passing of shareholder resolutions or admission to trading). The City Code is shortly to be amended to require that such conditions to underwriting are made non-waivable conditions of the offer itself. In practice, such requirement for a "hard" underwriting may, as with a bespoke debt facility, increase costs for the offeror.


The position can become more complicated if the offeror is a vehicle within a fund structure. Again, the level of detail required by the financial adviser will vary from transaction to transaction, but it may well encompass:

- Commercial assessment (probably through diligence meetings with fund executives) of the general nature and location of underlying investors, drawdown history and creditworthiness.
- A review of governing limited partnership agreements or (if, as is likely, they are confidential) a letter from the fund's lawyers as to the strength of funding obligations, the requirements for valid drawdown notices and the restrictions on drawdown application.
- Some comfort on the headroom levels of available funding or drawdowns within the funds.
- A review of the investment agreement and other terms on which funds will be advanced to and applied by the offeror vehicle.
- Comfort letters from a fund executive and/or the general partner as to the issue of drawdown notices or cash calls, and undertakings not to take any steps which would impede this.

PRIVATE M&A

From a seller's perspective, having a potential buyer produce evidence of certain funds is clearly ideal. For the reasons given above (not least the cost and amount of work required to produce certain funds documentation) it is unlikely that a potential buyer would willingly volunteer certain funds in a straightforward bilateral situation. However, it is increasingly the case that competitive auction processes are premised on certain funds being made available.

Although the process letter in a competitive auction may request certain funds – possibly even by reference to the City Code – there is no regulatory requirement to meet the stipulation; nor is there any requirement to persuade the financial adviser to the buyer of the quality of the finance package. It therefore becomes a simple question of the lengths to which the buyer feels it needs to go to provide the most compelling bid. It is quite common for buyers to make reference to certainty of funds but, on closer inspection, for the documentation to have caveats and conditions which would not meet the City Code standard. Likewise, the private M&A transaction may well involve a degree of conditionality which would not be permitted in a transaction governed by the City Code – with the financing arrangements being more flexible accordingly. In transactions where the buyer feels that its track record may be under scrutiny, or where its financing package has a large overseas or complex structured element, it may feel the need to provide irrevocable undertakings, letters of credit or even unconditional bridge financing pending other anticipated financing becoming unconditional.



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