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Fundamentals of Middle-Market Acquisition Financing

"Acquisition Financing" or the funding of capital for the purpose of acquiring a target company, is a growing specialty area among bank lending attorneys. While a catchy phrase, it can be a bit of a misnomer, in that different attorneys may represent providers of different levels of a company's capital structure on any one acquisition. Nonetheless, structuring a successful acquisition financing, particularly in the middle-market, can be daunting and demanding, no matter an attorney's role. In light of the increased prominence of alternative sources of capital available for buyers, this article will give a brief overview of some of the most common acquisition financing sources used in the market since the credit crunch, and strategies attorneys can utilize in structuring financings in today's dynamic lending world.

Types of Acquisitions

There are numerous ways one may acquire a company. Three principal methods of acquiring a business include: (i) purchasing a target company's assets (an "asset purchase"); (ii) purchasing the stock of a target company (a "stock purchase"); or (iii) merging the stock of one company with and into the other (a "merger") with one of such entities surviving the merger. In more complex acquisitions, two or more of these principal methods may be utilized; for example, a target company may be acquired by a stock purchase that is followed by a merger of the target with and into an acquisition vehicle owned by the buyer or another entity. Nonetheless, no matter what method or methods are employed, the chosen structure will play a significant role in any transaction because it will impact (i) the universe of liabilities and assets to be assumed by a buyer, and (ii) the sources of financing employed by a buyer.

In a traditional asset purchase, a buyer acquires specific assets and liabilities of a target company, as set forth in an asset purchase agreement. Upon consummation of the transaction, the buyer and seller maintain their separate legal existence. Asset purchases often require more third party consents than those needed for stock purchases or mergers, since many contracts acquired in asset purchases include anti-assignment clauses, limiting a seller's ability to assign such contracts to a purchaser. Many times the buyer will form a new shell entity to act as purchaser of the target's assets and it is this newly created entity that serves as the ultimate borrower for the financing. One benefit of an asset purchase to a buyer is that it will generally be able to negotiate which, if any, liabilities associated with the target assets will be assumed in connection with the purchase, rather than being required to assume all liabilities as is common in a stock purchase.

In contrast, in a stock purchase, a buyer acquires a target company's stock directly from the selling stockholders. The document evidencing the transaction is often called a stock purchase agreement. As a result of such stock purchase, a buyer acquires all of a company's assets and liabilities.[1] Upon consummation of the acquisition, although the target maintains its separate legal existence, it becomes a direct or indirect subsidiary of the buyer. Stock purchases are a common method for acquiring all or part of the stock of a private company or a division of a private company whose business is conducted through one or more distinct subsidiaries. Unlike asset purchases, stock purchases may require fewer third party consents with respect to assignment of company contracts; however, stock purchases may trigger change of control clauses in a target's existing contracts, which means receipt of consents of key constituents may be necessary as a condition precedent for closing.

Finally, mergers differ from both asset and stock purchases in that a target entity and a buyer do not maintain their separate legal existence upon consummation of a merger; instead, a target may merge with and into the buyer, with the target ceasing to exist (a "direct merger"), a target may merge with and into a wholly-owned subsidiary of the buyer, with the target ceasing to exist (a "forward subsidiary merger") or a wholly-owned subsidiary of the buyer may merger with

1. Purchase Agreements in stock purchase transactions will often require a purchase price reduction and/or pre-closing satisfaction of certain liabilities of the seller and include indemnification provisions to protect the buyer with respect to any contingent liabilities.

and into a target, with the wholly-owned subsidiary of the buyer ceasing to exist (a "reverse subsidiary merger"). Pursuant to a merger agreement, the surviving entity of the merger assumes (both by contract and, in most jurisdictions, as a matter of law) all assets and liabilities of the non-surviving entity. Similar to a stock purchase, various change of control clauses may be triggered as a result of a merger. Mergers are creatures of state corporate law, with requirements that vary from state to state (i.e., states vary in requirements to effect a short-form merger, voting criteria and the treatment of dissenting stockholders). A merger is the most common acquisition method for acquiring a public company, either in a one-step transaction or as the second step following a tender or exchange offer; however, it is also often used to acquire private companies with a large number of stockholders.

The acquisition agreements documenting asset purchases, stock purchases and mergers also vary in scope of representations, warranties and indemnification protections. As a result, thorough due diligence analysis of the assets and liabilities to be acquired or assumed in the acquisition is critical. No matter the acquisition structure utilized in any one transaction, the purchase price of such acquisition will commonly consist of some combination of cash, rollover equity issued to the sellers, promissory notes representing deferred purchase price, earn out payments contingent on the future performance of the business and/or other property. The purchase price, as well as post-acquisition organizational structure of a company, can in turn impact the types of financing tapped by a potential buyer.

Different Layers of Capital

In the middle-market, acquisition funding sources commonly include one or more of senior bank financing, mezzanine financing, seller financing, equity financing and/or asset-based lending. The business to be acquired, a buyer's existing leverage or credit rating, the projected value of a target's cash flow and assets, the importance of key personnel to be retained post-acquisition, the potential tax and legal liabilities, as well as market risk, all can impact the type of financing sources selected. An acquisition can be financed with debt or equity or a combination of both. The ratio between the debt and equity in any one deal, as well as the type of debt and equity availed of by a buyer in any one deal, varies based on the chosen acquisition structure and tax and business considerations.

Senior Bank Financing

Senior bank loans are borrowing arrangements whereby a borrower (who is often the buyer or an affiliate of the buyer in an acquisition) agrees to repay the borrowed amount at an interest rate that may fluctuate over time. Bank loans allow borrowers to have security by working with a specific institution that they are familiar with, and know can deliver funds on time.

There are various types of senior bank loans that a borrower may utilize in consummating an acquisition. Term loans are perhaps one of the most common sources of acquisition funds for borrowers. Typically, they are advanced on the closing date for a fixed period of time, such as three to five years, and are subject to some scheduled amortization, and a balloon payment at maturity. Importantly, term loans cannot be reborrowed even after they are repaid or prepaid; thus, when term loans are borrowed to consummate an acquisition, the closing of the acquisition is often concurrent with the closing of the credit facility. In other circumstances, a borrower may make borrowings of delayed draw acquisition loans, which are loans that a borrower may draw within a defined availability period for purposes of consummating future permitted acquisitions under a credit facility. In certain agreements, revolving loans are also available for acquisitions, although quite commonly, revolving loans are used primarily to provide working capital. In some transactions, a borrower may be able to exercise an accordion or incremental facility under a loan agreement to obtain additional loans, and use such proceeds of the accordion or incremental facility for purposes of consummating a subsequent acquisition.

Lenders often make senior secured loans to borrowers, which require comprehensive collateral and guaranty packages from the borrower, the direct parent of the borrower, the target and any subsidiaries (commonly referred to as "loan parties"). To the extent lenders perfect their security interests in the assets of the loan parties, they will have the ability to foreclose on such collateral in the event the borrower fails to repay the loans or breaches the other terms of the applicable loan agreement. Importantly, if the borrower becomes insolvent, secured lenders have priority over other creditors under the U.S. Bankruptcy Code.

Acquisitions are sometimes financed with both first and second lien facilities ("first lien/second lien facilities"). In a first lien/second lien facility, two separate classes of lenders are granted liens on the same collateral with the lien in favor of the first lien lenders benefitting from "priority" status as to the second lien; in the event there is an event of default under both facilities, pursuant to the terms of a negotiated intercreditor agreement (the "intercreditor agreement"), the first lien lenders are entitled to receive repayment of their loans and other obligations up to a negotiated cap, from the proceeds of the collateral before the second lien lenders receive any repayment from such proceeds. It is important to note that pursuant to the intercreditor agreement, the second lien lenders are not subject to payment subordination (i.e., first lien lenders have no payment blockage rights with respect to the second lien lenders), but only lien subordination to the liens in favor of the first lien lenders. Lien subordination

occurs when second lien lenders contractually agree that their liens will be subordinated to the liens in favor of the senior or "first lien" lenders. Unlike mezzanine debt, second lien loans are secured by a pledge of specific collateral of the borrower (i.e., equipment, intellectual property, receivables, accounts and other assets that secure the first lien obligations); however, as noted above, the second lien lenders agree that any collateral proceeds are first applied to satisfy any first lien obligations prior to the payment of any second lien loans.

Mezzanine Financing

In recent years, there has been an increased use of mezzanine financing in acquisitions. Mezzanine financing, also known as funding of mezzanine capital, refers to a tier in the company's capital structure between debt and equity. Most commonly, mezzanine financing takes the form of subordinated, unsecured loans, but in other cases, it takes the form of subordinated securities or a standalone equity investment in a company.

Debt may be subordinated in three main ways: (i) contractual subordination, (ii) structural subordination or (iii) lien subordination. Contractual subordination occurs when there is an explicit agreement from the subordinated debtholders that senior debt does exist or may exist; contractual subordination often takes the form of a subordination agreement or intercreditor agreement pursuant to which the junior creditor agrees to postpone payment of the junior debt until the prior payment in full of the senior debt. Two basic forms of contractual subordination involve (i) subordination in assets or liquidation preference and (ii) subordination in right of payment. In contrast, structural subordination occurs based on where in a company's organizational structure a lender extends credit. To illustrate, if a lender loans money to a parent company with no significant operations or assets other than its ownership of the equity of the cash generating operating subsidiary, such lender will be structurally subordinated to a lender that loaned money directly to the operating subsidiary that that is lower in the company's organizational structure; assuming the lenders to the operating subsidiary take a lien on the assets of the operating subsidiary that lender will be structurally senior, and the parent company lender can only be repaid from any of the operating subsidiary company's assets remaining after all debt of the operating subsidiary has been repaid in full. No intercreditor agreement is needed for structural subordination to apply; however, lenders should be mindful as to whether the particular aspects of a given transaction warrant a written subordination agreement.[2] Mezzanine debt is often contractually subordinated, but it may sometimes be both structurally and contractually subordinated to other sources of financing. Due to the higher rate of return received by mezzanine debtholders, mezzanine debtholders often agree to be contractually subordinated to both existing and future holders of certain senior debt.

Senior bank lenders often require mezzanine lenders to agree to a number of limitations in mezzanine loan agreements and mezzanine intercreditor agreements with respect to subordinated debt, such as: (i) the inclusion of payment blockage and standstill provisions applicable to the mezzanine lenders during the continuance of an event of default, (ii) limitations on the rate of interest payable in cash in respect of the subordinated debt with an additional cap on the rate of interest payable-in-kind, (iii) such subordinated debt may not be permitted to amortize and may mature no earlier than 180 days after the senior bank loans' maturity date, (iv) the documentation evidencing such subordinated debt is often subject to cushions of approximately ten percent (10%) to fifteen percent (15%) from the senior bank loan agreement's basket amounts in the negative covenants, events of default and financial covenants, and (v) mezzanine loan obligations will not be permitted to cross default to any senior indebtedness of the borrower and its subsidiaries (including the indebtedness under a senior bank loan agreement). Additionally, senior bank loan agreements often include a maximum principal amount of mezzanine debt that may be incurred by a borrower, and restrictions on the use of proceeds thereof (i.e., mezzanine debt may not be permitted to be used to finance the payment of dividends and distributions to equityholders of the borrower). Frequently, mezzanine loan agreements include redemption rights and call protection provisions, which should be carefully considered by senior lenders.

Most mezzanine financing takes the form of subordinated, unsecured debt. From time to time, mezzanine financing may benefit from the grant of a "silent second lien" on the collateral securing the senior debt. The addition of the "silent second lien" requires significant additional revisions to a typical mezzanine intercreditor agreement in order to define the relative rights of the parties with respect to the collateral. In instances where the mezzanine debt constitutes "insider" subordinated debt that is provided by an equity sponsor or affiliate of the borrower, senior bank lenders will often require "deep and dark" subordination agreements with such equity sponsor or affiliate of the borrower in order to limit the rights and remedies of the holders of such debt in a manner much more similar to the holders of equity. Such subordination agreements typically provide for a permanent blockage on any mezzanine debt principal payment to be made prior to the payment in full of the senior debt.

2. For example, in the event the holder of debt that is intended to be structurally subordinated also holds debt or equity at another level in the corporate structure, it may be preferable for the senior lenders to insist on contractual subordination rather than relying solely on the structural aspects of the debt structure.

Seller Financing

Unlike senior and mezzanine financing, in which a third party financial institution often makes a loan to a borrower, seller financing involves a loan provided by the seller of a business to a buyer, which may be a borrower or an affiliate of a borrower under a separate credit facility. Often, the buyer will pay a portion of the purchase price in cash (which may be financed through the issuance of debt and/or equity) on the closing date, and the remainder of the purchase price is evidenced by a note issued by the buyer, which is payable to the seller in one or more future installments. Seller financing is beneficial to a buyer since the buyer may not be able to secure sufficient senior or mezzanine capital to finance the entire purchase price of an acquisition on the closing date. Seller financing can be beneficial to sellers, as well, since it may sometimes result in an overall higher selling price than if the seller had only received cash on the closing date. In the event acquisition funding sources consist of senior bank financing and seller financing, the senior lenders will often insist that the seller to agree to subordinate its debt in right of payment to the prior payment of debt owing to the senior lenders. Sometimes, this can be accomplished with language in a purchase agreement, but often, this is effectuated by a separate subordination agreement executed by the seller in favor of the senior lenders.

Equity Financing

Equity financing consists of the offer and sale of a buyer's equity securities for purposes of (i) raising capital to pay all or a portion of the purchase price for an acquisition and (ii) providing working capital for the acquired company. Buyers can seek equity from a variety of sources, ranging from private equity firms to venture capitalists to individual investors. In comparison to debt financing, which must be repaid over time, certain types of equity financing do not include a scheduled maturity or redemption date. Instead, equity provides investors with ownership interests in a target company. In addition, equity investors may also participate as a member of the company's board of directors and take an active role in managing a company. Because of this important role that equityholders can have in a company, senior and mezzanine lenders often closely review loan parties' organizational documents to determine information as to permitted classes of stock, put and redemption rights, drag-along rights, tag-a-long-rights, voting rights, board member rights, and the like, prior to lending to a company.

Asset-Based Lending

Finally, asset-based financing is another mechanism associated with acquisitions. Asset-based loans are generally senior revolving loans secured by a company's current asset collateral, such as inventory and accounts receivable. In a typical asset-based facility, borrowings are governed by a borrowing base which limits the amount that can be borrowed to a percentage of the company's current assets (often between sixty-five percent (65%) to eighty percent (80%)). Asset-based revolving facilities are often combined with traditional term loans or high-yield note tranches when used in connection with an acquisition financing.

The main difference between asset-based acquisition lending and senior or mezzanine bank lending is the lenders' credit focus when underwriting a loan. Whereas a senior or mezzanine lender may first look to cash flow and enterprise value and then collateral, an asset-based lender will first look to collateral. Companies will routinely utilize asset-based lending or traditional senior or mezzanine bank lending in consummating an acquisition, but rarely all three forms of financing. Asset-based acquisition financing is particularly relevant in industries where the proposed acquisition is in an industry where working capital assets dominate the balance sheet (i.e., manufacturers and distributors of goods).

Conclusion

No one acquisition financing is identical, and there are no universal requirements in achieving the ideal funding. Securing the best financing sources for an acquisition can be daunting and demanding, but it can also be rewarding if well planned. Because of the sensitivity involved by all tiers of debt and equity in any one transaction, it is important for potential buyers of a company to determine from an early stage what will be the source of funds in an acquisition.

For More Information

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