Bidders' burden

Buyers looking to finance acquisitions in government-run auctions are finding that certain funds are often not certain enough

In the context of an auction to purchase a privately-owned business, private equity and similar financial bidders have long been accustomed to the requirement of having to obtain a firm commitment from their lenders to provide the debt financing necessary to complete the acquisition – and to submit evidence of this commitment as part of their bid package.

In the European context, this evidence typically consists of a commitment letter whereby the lenders undertake to provide the proposed financing on so-called certain funds terms. Whilst that definition has no fixed meaning, it typically features a commitment to provide the financing on the sole condition that all conditions precedent to the acquisition agreement have been satisfied and that the bidder has complied with certain additional requirements that are within its control (chiefly, the making of a minimum equity contribution to the borrower, the absence of fundamental defaults by the acquisition vehicle and the delivery of customary corporate documents). Such a structure still leaves documentation risk – because the bidder must turn the commitment into a full credit agreement. So in many cases, a draft of a short-form interim facility agreement is agreed at the same time as the commitment letter.

> There are times when bidders must go even further than an interim facility agreement

A committed financing of this sort typically satisfies both the need of the seller to ensure that the bidder has the wherewithal to complete the transaction, and that of the bidder that it will not find itself in breach of the acquisition agreement as a result of its lenders failing to provide the financing.

However there are times when bidders must go even further than an interim facility agreement. Where the seller is a government entity or a government-controlled corporation, or all or part of the assets are deemed government property, for example, the auction may involve a set of processes that are akin to those required by law for awarding public contracts. These requirements may include the posting by each bidder, on the date of the offer, of a bank guarantee for the full amount of the purchase price offered by the bidder. Indeed, this was the legal framework that applied to the recent highly contested auction for Grandi Stazioni Retail – the retail lease operations of the Italian railway system.

Legal and practical challenges

Such a seemingly innocuous requirement poses fresh legal and practical challenges, particularly for private equity bidders. While a comparison can be drawn to a stock tender offer, where, in various European jurisdictions, a bank guarantee needs to be issued to the market regulator at the time the offer is launched to secure the payment for the tendered shares – the similarities mostly end there. When a tender offer is launched over the shares of a public company, the offeror usually has already acquired a controlling stake in the target (with the acquisition triggering the obligation to launch the tender offer for the remaining shares). So an initial closing of the transaction has already occurred, resulting in the offeror being fully capitalized. Further, tender offers are subject only to easily ascertainable conditions (if any), such as minimum take-up. Thus, it is highly unlikely that there will be any discussions on whether such conditions have been satisfied.

From the perspective of the bank issuing the bid guarantee required in these government-run processes, the issuance is tantamount to disbursing cash on the date the guarantee is delivered, as the guarantee will typically not contain any condition to the seller drawing its full amount. Moreover, because the bid guarantee is for the full amount of the purchase price, it needs to cover both the amount to be provided by the lenders in the form of debt as well as the amount to be funded by the sponsor as equity.

As a consequence, the bid guarantee bank will be taking exposure to the sponsor as well as the lenders. For this reason, a useful conceptual distinction can be drawn in these cases between the portion of the bid guarantee backed by the equity (the equity guarantee) and that backed the lenders' commitments (the debt guarantee), as the two represent, in principle, different transactions and exposures by the issuing bank.

The debt guarantee

With respect to the debt guarantee specifically, the bid guarantee bank will need to ensure that, if it is drawn upon, it will promptly be reimbursed by the lenders providing the debt financing. This, in turn, requires that a definitive loan agreement (as well as all related security documents) – on certain funds terms – be entered into no later than the time of the bid whereby the lenders undertake to indemnify the guarantee bank if the guarantee is called upon. Secondly, given the unconditional nature of the guarantee, the guarantee bank as well as the lenders will need to ensure that all things that would otherwise have been a condition to them taking a credit exposure on the borrower (ie those that would normally be CPs to funding of the loans) are in place at the date of the bid. Among other things, this means that, with respect to the condition relating to the sponsors' equity contribution, the bid guarantee bank and the lenders will at a minimum seek to be able to rely on an equity commitment letter from the sponsor to ensure that the equity is actually funded on closing.

Notwithstanding all the precautions that can be taken in this regard at the time of the bid, however, some risk will remain that, by the time the acquisition closes, the bid guarantee will be drawable even where the lenders would not otherwise have been legally required to fund. This could result, for example, from the sponsor not actually having made its equity contribution, the sponsor's acquisition vehicle having violated its limited certain funds undertakings under the loan agreement or having amended the acquisition agreement without the consent of the lenders, or an illegality event having occurred with respect to one or more lenders. Addressing these contingencies may give rise to difficult discussions between the guarantee bank and the lenders as to whether the lenders should nonetheless disburse the loans in order to refund the guarantee bank in those circumstances. This and other thorny issues can often be eased if each of the lenders can be persuaded to issue a pro rata portion of the bid guarantee, so that their interests become aligned with those of the guarantee bank.

Such dynamics between the bank issuing the debt guarantee and the lenders of the debt financing also affect the ability of the initial lenders to transfer or otherwise syndicate their commitments during the period in which the guarantee may be drawn upon. Here, in addition to the limitations that would typically be imposed by the borrower to ensure certainty of funds, the guarantee bank will itself be taking counterparty risk on the lending syndicate and, as a result, will seek to impose restrictions on the profile of its counterparties.

For similar reasons, the requirement to issue the debt guarantee often makes it impractical for the sponsor to finance all or a portion of the acquisition by tapping into the growing direct lending market, because alternative asset managers often lack the credit standing (and rating) of commercial banks and are thus unsuitable counterparties to counter-indemnify the bid guarantee bank.

The equity guarantee

The requirement to deliver the equity guarantee raises its own set of challenges. The bank issuing this guarantee will depend on the sponsor actually making its equity contribution for the guarantee not to be drawn upon by the seller (or, if drawn, for it to be promptly reimbursed). As a result, the guarantee bank will also seek to be able to enforce the equity commitment letter and/or obtain a direct counter-indemnity from the sponsor. Because the guarantee bank is taking credit exposure on the sponsor, it will need to run a full diligence process over that entity, including the nature of its limited partners, the amount and quality of their undrawn commitments, and the sponsor's other existing investments. This can be a time-consuming exercise that the guarantee bank may or may not be well equipped to carry out, depending on, among other things, the jurisdiction of the transaction and where the sponsor is located. If the sponsor already has a subscription or capital call facility in place, as is increasingly common, the bank providing the facility could be best placed to carry out the analysis and issue the equity guarantee directly or, alternatively, provide a back-to-back letter of credit to support such issuance.

In the event that, for whatever reason, the credit support from the sponsor is insufficient, the equity guarantee bank may seek to obtain a pledge over the acquisition vehicle, so that, in the event of a default by the sponsor on its equity commitment, the bank can foreclose over an entity that can be assumed to have positive equity value promptly after the closing of the transaction.

This request will give rise to further intercreditor discussion, however, as the lenders providing the debt financing will also expect to enjoy the benefit of a pledge over the same entity. The lenders may in fact take the view that, to the extent that the guarantee bank is willing to grant credit to the sponsor, it is taking equity risk in the transaction and its security interest, if any, should be subordinate to theirs or, preferably, be taken over an entity sitting above the acquisition vehicle in the corporate chain.

Similarly, the lenders may require that the guarantee bank waive or subordinate to their liabilities any subrogation claim it may have against the acquisition vehicle for having paid a portion of the purchase price on its behalf. This would avoid a situation where the acquisition vehicle is saddled with an additional unexpected liability that competes with the debt financing as a result of the equity guarantee having been drawn upon.

> **The guarantee bank will itself be taking counterparty risk on the lending syndicate**

The fact that the guarantee needs to be issued at the time the offer is first submitted, when there is still a high degree of uncertainty over whether the offer itself is going to be successful, puts an additional strain on the discussions around financing fees. In a conventional bid situation, it is common for a sponsor only to commit to pay these fees if the deal eventually closes. However, the banks do not typically sign definitive documentation and incur the related capital charges until at least an acquisition agreement is signed and, therefore, there is a very high likelihood that the transaction will go through. Because, here, the issuance of the bid guarantee triggers an immediate capital charge at a time when the bidders are still competing with each other, the bidders may be under pressure to accept that they will have to pay some portion of these fees even if their offer is rejected or the deal does not otherwise close.

Advance planning

Participating in an auction of this sort requires each bidder effectively to consummate the closing of its financing as early as the date of the bid. Achieving this in the tight timeframe typically imposed by a competitive auction process requires an amount of planning, lead time and available resources that should not be underestimated.

By Cleary Gottlieb Steen & Hamilton partners Carlo de Vito Piscicelli and David Billington