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Asset deals: issues in connection with the Swiss Merger Act

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The Swiss Merger Act (MA) entered into force on 1 July 2004. One of its goals was to facilitate the transfer of assets and liabilities (e.g., a business or part of it). However, nearly 10 years after the coming into force of the MA several aspects of the law remain controversial. One of these aspects is of high importance for asset deals in Switzerland: how shall existing contracts with third parties – belonging to the transferred business segment – be treated? Our article outlines the current situation and indicates possible solutions.

Legal framework regarding the transfer of assets and liabilities under the MA (the 'MA Transfer Regime')

The MA covers mergers, demergers, conversions and the transfer of assets and liabilities. Its primary purpose is to facilitate the restructuring of companies via the aforementioned institutes. The incorporation of the transfer of assets and liabilities into the MA has to be seen in that context. As this institute is part of the MA, some argue that it should only be used for the restructuring of companies, i.e., to transfer a business or part of it. However, there being no explicit provision

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regarding the institute's scope of use in the MA, others argue that the MA Transfer Regime allows for transfers of specific assets also in situations where there is no transfer of a business or business segment.

Transfer of assets and liabilities in one act

Prior to the existence of the MA, each asset had to be transferred by way of singular succession (*Singularsukzession*). The MA introduced a substantial alteration to the manner in which assets (and liabilities) can be transferred by introducing a concept allowing the transfer of a multiplicity of assets and liabilities in one act via the so-called partial universal succession (*partielle Universalsukzession*) whereby the general rules (in particular formal requirements) for the respective assets and liabilities do not have to be complied with.

Among other, the following requirements have to be met for such a partial universal succession: (i) a written transfer contract has to be concluded by the supreme managing or administrative bodies of both transferor company and transferee company (if parcels of real estate are transferred, the respective parts of the contract require a public deed); (ii) the transfer contract has to contain an inventory with the precise designation of the items of the assets and liabilities to be transferred; and (iii) the transfer has to be registered in the Commercial Register.

The transfer contract has to be submitted as evidence to the Commercial Register which is publicly accessible. As the inventory forms part of the transfer contract, it is also in the public domain. This can lead to problems regarding confidentiality and data protection in connection with contracts with third parties. At least according to the practice of the Commercial Register of the Canton of Zurich, the requirement of an inventory with "precise designation of the items" is, in connection with the transfer of a business or a business segment, already fulfilled for contracts if they are determinable for third parties. Voices in the Swiss doctrine argue that confidential information can be paraphrased in the inventory. Hence, the problem regarding confidentiality and data protection is somewhat reduced.

According to Art. 73 para. 2 MA, the transfer of assets and liabilities shall become legally effective only upon entry in the Commercial Register, i.e., the entry in the Commercial Register has constitutive effect. As of that date, all assets and liabilities listed in the inventory are transferred by operation of law to the transferee company.

In comparison with a traditional asset deal (using the singular succession) the transfer of assets and liabilities under the MA (using the partial universal succession) seems advantageous. However, there still remains insecurity over whether contracts with third parties can be transferred by partial universal succession under the MA Transfer Regime without the consent of such third parties. It goes without saying that companies interested in using the MA Transfer Regime need to know for certain whether the relevant contracts are indeed transferred irrespective of the contractual third parties' consent or not.

Controversy regarding the transfer of existing contracts with third parties

This controversy goes back to the legislative procedure where the scope of use for the partial universal succession remained unclear. It was argued that a transfer of contracts with third parties in a partial universal succession (and hence without the consent of the third party) would be in danger of abuse and should therefore

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not be permitted. Other voices argued that the provisions of the MA would not prohibit such a transfer and that any other interpretation of the MA would be against the primary purpose of the law (to facilitate the restructuring of companies).

The following three opinions in particular have been voiced in the Swiss doctrine (there is no case law yet regarding the MA Transfer Regime): (i) some authors argue that the MA Transfer Regime is not admissible to transfers of contracts with third parties and the third parties' consent is thus still required; (ii) others argue that the MA Transfer Regime can also be used without reservation for contracts with third parties; and (iii) exponents of the third opinion argue that contracts can be transferred under the MA Transfer Regime (without the counterparties' consent) if they are part of a transfer of a business segment and the contract itself is linked thereto.

Today, the (clear) majority view in Swiss doctrine is of the opinion that the MA Transfer Regime can be used for transfers of contracts with third parties without the prior consent of such third party. Furthermore, in January 2006 the Swiss Federal Supreme Court ruled in a judgment regarding a demerger that a partial universal succession is in terms of its quality an adequate universal succession and that the 'partial' only refers to the scope of the transfer – being limited to the assets and liabilities specified in the inventory (the transfer rules for demergers are very similar to those regarding the MA Transfer Regime). However, as mentioned above, it has to be noted that this controversy has so far not been resolved by case law squarely addressing this issue under the MA Transfer Regime.

Conclusion

Therefore, it still remains somewhat unclear whether transfers of contracts with third parties require their consent. It remains advisable to seek the consent of all involved third parties prior to the transfer of a contract until the situation is finally settled by a judgment of the Swiss Federal Supreme Court. ■

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SPECIAL REPORT

Q&A: Financing options in M&A

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Q&A

Financing options in M&A

FW moderates a discussion on financing options in M&A between Andrew Cheng at Gibson, Dunn & Crutcher LLP, Chuck Yamarone at Houlihan Lokey, Andreas Moll at Prager Dreifuss Ltd, and Sabrina Rusnak-Carlson at Proskauer Rose LLP.

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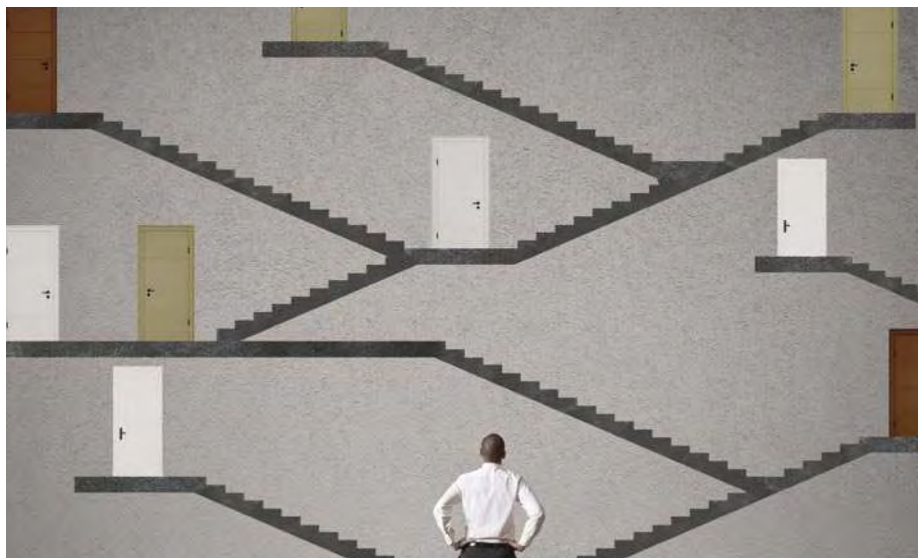
FW: How would you describe general liquidity levels for M&A financing in the current market? To what extent is debt available to support M&A activity?

Cheng: General liquidity levels for M&A financing are still good, but the market is a bit choppy at the moment. We have some acquisition financings that are getting done without much of an issue and others that are having more difficulty in syndication. For some deals at least, we are seeing the effects of recent outflows from mutual funds and a significant volume of supply hitting the market. Also, some banks appear to be struggling with participating in deals where the borrower will exceed 6x leverage, in light of the Interagency Guidance on Leveraged Lending issued by the Federal Reserve, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corp.

Yamarone: Although the pace of high yield and leveraged loan originations has fallen about 10 percent from last year's record levels, strong investor demand and liquidity continue to drive yields lower and allow for aggressive capital structures. I would note that conditions are particularly robust in the middle market, where business development companies (BDCs) and other direct lending vehicles continue to proliferate. Meanwhile, the continued increase in collateralised loan obligation (CLO) issuances is providing additional liquidity for larger transactions. These



strong financing conditions are expected to fuel an increase in leveraged buyout (LBO) and M&A activity in 2014, though M&A volumes will ultimately depend on valuations remaining at levels where buyers can achieve acceptable returns at current leverage levels and pricing.

Moll: Liquidity levels for M&A financing are high in general in the current market and debt is available at least for solid transactions. These positive signs indicate a recovery of global M&A activity which is also demonstrated by the latest news regarding the bids for Alstom and AstraZeneca after the first quarter of 2014, where a number of big deals – partly financed by debt – have already taken place. The European market has recovered well after a quite difficult 2013 for M&A deals. It seems that market participants are on the lookout for M&A opportunities this year.

Rusnak-Carlson: While there is ample liquidity for M&A financing, the demand for debt has not kept pace with the supply. As a result, there is intense competition among debt providers to win deals. Despite the competitiveness of the market, there is a fight for quality deals and lenders are exercising discipline, especially for lower quality credits. In order to win quality deals with an attractive yield, lenders are forced to be creative with pricing and structure.

FW: How would you describe the appetite of senior lenders when it comes to providing transaction financing? What seems to be the prevailing attitude toward long duration commitments and high leverage levels, for example?

Yamarone: Given the strength of the financing markets, senior lenders are aggressively competing to provide acquisition financing, especially for sponsor-backed transactions. The continued flows of capital to non-bank senior lenders, as well as increased competition from BDCs and other direct lenders for deal flow, have pushed senior lenders into higher leverage levels and towards 'covenant-lite' or 'covenant-loose' structures in larger transactions. However, we have not seen any significant trend toward longer maturities in the senior debt market, though both the high yield and investment grade bond markets have been very accommodating to longer maturities.

Moll: After the crisis of 2007-2008 senior lenders were looking for more conservative deals and were keen to minimise risk. More recently, the big deals so far in 2014 show that the risk appetite of senior lenders is growing again. The trend regarding more aggressive deals goes along with rising leverage levels – we observe this particularly in transactions taking place in Europe. As long as general market conditions do not change we would expect this trend to continue for the remainder of 2014.

Rusnak-Carlson: For quality deals, institutional bank lenders are aggressively pursuing transaction financing. However, we are starting to see the effects of regulatory changes impact their lending capacity. Also, institutional banks are facing increasing competition from BDCs and other alternative lenders. In the past, these alternative lenders primarily provided junior capital, but within the last year and a half, alternative lenders, especially BDCs, have moved aggressively up the balance sheet and are now providing senior loans in conjunction with, if not in competition to, traditional institutional bank lenders. Furthermore, they are also starting to demonstrate capacity to go up market and have shown willingness to be aggressive on terms and structure, including longer duration commitments and higher leverage levels.

Cheng: Overall the appetite of senior lenders to provide transaction financing is still good to very good depending on the deal, but with less money flowing into the market and a large forward calendar, investors have more leverage at the moment than they have recently had. Consequently, a highly leveraged deal may face some pushback right now. Given the Interagency Guidance, 6x leverage is a line that some banks are reluctant to cross. While this is not to say that highly leveraged deals cannot get done, they seem to be the exceptions at the moment. We have not seen anything particularly noteworthy with respect to length of commitments, which in general remain shorter than they were pre-downturn. But banks are willing to entertain a lengthier commitment or some sort of built in commitment extension to the extent that there is a deal-specific reason why there might be a lengthier gap between signing and closing.

FW: Could you provide an insight into the kinds of debt multiples applied to senior debt in recent transactions? Is asset-based lending playing a meaningful role?

Moll: In most of the recent transactions we have been involved with, asset-based lending played an important role. In some cases the set-up of the loan would have collapsed without assets being available as securities. Particularly common as securities for loans are the pledge of shares, the pledge of bank accounts, the pledge of intellectual property rights or the assignment of receivables.

Rusnak-Carlson: Debt multiples run a gamut, but overall there has been a general increase. More traditional bank lenders are generally staying 'inside the box' – below 3.75x total leverage. Alternative lenders are aggressively lending deeper into the capital structure for quality credits by funding an entire facility or partnering with traditional banks, including asset-based lenders, to provide one-stop debt or unitranche solutions for borrowers. Leverage in such structures is usually up to around 4.50x total leverage, with some stretching as far as 6x total leverage in the right deals.

Cheng: We are currently seeing leverage of between 4-5x, which is generally consistent ▸▸

with the 2014 first quarter numbers reported by S&P Capital IQ LCD, with large corporate loans averaging 4.93x leverage and middle market loans averaging 4.59x leverage. To the extent that you have a borrower which has the correct profile for an asset-based facility, asset-based lending can play a meaningful role in an acquisition financing. Recent examples include the acquisition financings for Men's Wearhouse and Nine West.

Yamarone: While senior lenders are behaving very aggressively, they are still requiring significant equity contributions – 30 to 40 percent – in the vast majority of transactions. Accordingly, debt multiples are largely dependent on the enterprise value of the new borrower. Banks have increased their first lien leverage tolerance heading into Q2 2014 lending at approximately 3.5-4x EBITDA, but are still staying more disciplined relative to their leverage tolerance prior to the financial crisis. The asset-based lending (ABL) market still plays a meaningful role, especially for smaller borrowers with significant working capital needs or limited free cash flow.

FW: What types of subordinated debt options appear to be popular at present? Is there a strong pool of 'alternative' or 'non-traditional' lenders looking to contribute M&A financing?

Rusnak-Carlson: The unitranche product is the most popular product. While we have been structuring unitranches for 10 years, the popularity of the unitranche has exploded in the past year and a half. Unitranches have now become a platform for a multitude of structures, including one-stops, first-out/last-outs, synthetic second liens and mezzanine structure, split collateral and even up-side down firsts. Sponsors appreciate unitranche facilities because the one document structure is simpler and more cost efficient to execute than a traditional two document structure and may allow alternative lenders to stretch deeper into the capital structure.

Cheng: At present, what has historically been considered subordinated debt seems to have largely fallen by the wayside and been replaced by unitranche structures, second lien debt or senior high yield notes, which in each case is technically senior debt. The increase in the issuance of second lien debt is particularly striking, with Bloomberg reporting that in the first quarter of 2014 second lien loan issuance jumped to an all-time high for any first quarter. There is definitely a pool of alternative non-bank lenders that has gained in presence over the past several years, which consist primarily of BDCs and funds dedicated to making senior loans. One caveat is that these alternative non-bank lenders play primarily in the middle market to lower middle market space, which impacts the magnitude of the M&A financings where such lenders can take the lead. Also, given the segment of the market on which these alternative lenders focus, their borrowers are likely going to have to live with a more robust covenant package – including maintenance covenants – than would borrowers under large cap syndicated bank facilities.

Yamarone: In the larger transactions, the high-yield bond market continues to be very accommodating as investors' leverage tolerance remains high. For middle market issuers without access to the liquid markets, increased competition has forced mezzanine players to pursue riskier credits, especially given senior lenders' willingness to stretch deeper into the capital structure. The 'unitranche' solution remains very attractive as alternative lenders, including BDCs and private debt funds, are actively looking to put capital to work. Though these funds' return thresholds are higher than traditional senior lenders, they can offer higher leverage, a flexible structure, and both speed and certainty of execution.

Moll: Particularly in Europe, the issuance of subordinated bonds designed to absorb losses is popular at present. This development started in 2013 and is continuing so far in 2014. In our experience, larger companies still rely on banks in particular as their traditional lenders and we are not aware of a strong pool of 'alternative' or 'non-traditional' lenders pushing for their share in this segment of the M&A market. However, we are aware that companies involved in smaller M&A transactions these days sometimes use these alternative ways to get the necessary funds, instead of taking the laborious route of negotiating a loan with a bank.

FW: Are certain types of transactions more likely to receive financing? What characteristics are lenders looking for in a prospective deal?

Cheng: Right now, sponsor deals under 6x leverage are more likely to get done on terms that would be acceptable to the borrower than dividend recaps and re-pricings, a few of which have been pulled over the past few weeks in light of investor pushback. Obviously, lenders are going to be looking for yield, and are also going to be looking for call protection to lock in that yield. It also seems that investors are taking a closer look at some of the bond-like features that are appearing in loan documentation. In particular, deals where restricted payments, investments in non-loan parties and permitted acquisition debt are subject to more meaningful caps would be attractive to investors.

Yamarone: Even in today's hot market, lenders continue to prefer acquisitions by a prominent financial sponsor or a reputable strategic acquirer. As with all credits, lenders prefer a demonstrated and consistent level of cash flows with minimal capital expenditure (capex) requirements – two to three years of steady historical performance – a business model with recurring revenue streams or long-term contracts, and a strong collateral base. In 2013, nearly two-thirds of all new issuances were in the TMT, industrial, and services and retail industries, with a notable decline in the aerospace and defence sector. We expect these trends to remain consistent in 2014.

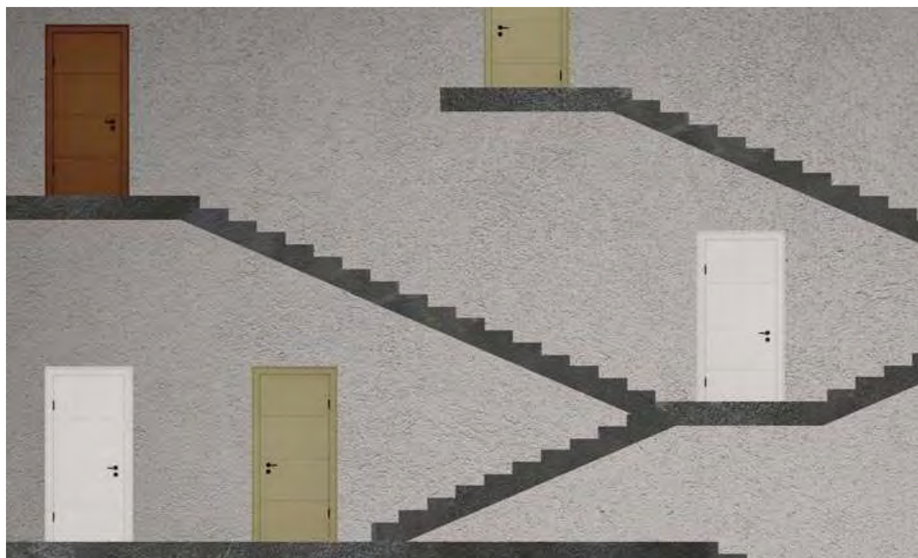
Moll: On the one hand, lenders, in particular banks, are looking for conservative funding in transactions which give them a convincing package of profits and securities. On the other hand, we can see a trend regarding more aggressive deals including higher leverage levels and looser covenants, as lenders are competing for transactions in a recovering M&A market. In the next few months, it will be interesting to see which of these two conflicting arguments gets the upper hand, from a lender's perspective.

Rusnak-Carlson: Lenders are fighting to provide financing for quality credits – companies that show strong balance sheets and revenue models, are operating in stable industries, and have quality management and sponsors. For such quality credits, lenders are challenged to maintain yield and exercise discipline on structure.

FW: Are you seeing signs of a return to 'covenant-lite' debt structures?

Yamarone: 2013 clearly marked the return of covenant-lite structures as the new norm, with approximately 57 percent of first lien loans allocating without a covenant, the highest level in 10 years. Issuers have taken advantage of strong lender demand to introduce a covenant-loose structure, with wider covenant cushions and ratios in lieu of covenant-lite. This trend is expected to continue into 2014 given the favourable supply and demand dynamic for issuers.

Moll: Covenant-lite debt structures can be seen again in recent deal structures. This is



particularly true for deals involving US lenders. The debt structures we see in Europe tend to be more conservative in this regard and, consequently, covenant-lite debt structures are not that common. Nevertheless, it is obvious that lenders want to profit from the favourable financing conditions. Provided that such conditions prevail, a further rise of covenant-lite debt structures is possible in Europe as well.

Rusnak-Carlson: Covenant-lite debt facilities are returning to the US middle market in addition to upper market terms coming down to the middle market in quality credits. Some examples of more upper market terms moving down to the middle market include builder baskets, debt incurrence tests, flexible accordions, and unrestricted builder baskets.

Cheng: In large cap deals and in larger middle market deals, covenant-lite structures have definitely returned, with LCD reporting that 60 percent of new-issue loans were covenant-lite in the first quarter of 2014, which is actually a slightly lower percentage than in the two previous quarters. The cut-off in facility size where you can receive a covenant-lite loan seems to be around $200m. One thing to note is that given recent market conditions, we have seen a few refinancings of covenant-lite facilities where the borrower had to add a leverage covenant to get the deal done.

FW: What impact is the interest rate environment likely to have on M&A financing through the remainder of 2014?

Moll: The interest rate environment prevailing at present will certainly help to drive the trend towards a global recovery of the M&A market. At the same time we would expect the availability of cheap funds to be one of the ingredients leading to further big M&A transactions as already seen in the first quarter of 2014. Of course there will always be risks – for example, geopolitical or regulatory – and consequently rising interest rates are a possibility. In particular, if the euro crisis should get worse again, this may have a negative impact on the economy and the overall interest level. However, up to the present, there are no concrete indications that the interest rate environment is about to change in the near future.

Rusnak-Carlson: We have seen strong activity for the past year and a half. Alternative lenders have had no problem raising capital. If interest rates hold steady and the capital markets remain stable, then we expect M&A financing activity to continue to be strong throughout the balance of 2014.

Cheng: While it seems commentators do not expect the Federal Reserve to materially tighten interest rates for the remainder of 2014, we have seen a marked increase in pricing over the past several weeks. To the extent that this increase does not prove to be temporary, this suggests to us that the interest rate question is not going to be whether or not there is demand, but whether the clearing price is going to work for the buyer. That being said, on the demand side, what we are keeping an eye on is whether the regulatory environment will depress CLO issuance and the ability or willingness of banks to participate in leveraged financings. While the fears with respect to CLO issuance have not yet been realised, some banks are looking very closely at financings that exceed 6x leverage.

Yamarone: In the past couple of months, the credit markets have adjusted to the Federal Reserve's actions to incrementally reduce its bond purchase program, with treasury yields about 30 bps below year-end 2013. Generally, I would expect short term rates to remain at historically low levels well into 2015. The liquidity provided by CLO issuances and fund flows to leverage loan mutual funds have created an appetite for the credit of the largest borrowers, which should continue to drive M&A activity for the rest of the year.

FW: What advice can you offer to acquirers on structuring and financing M&A deals in light of today's market conditions? How can acquirers achieve an optimal capital structure?

Rusnak-Carlson: Today's market conditions reflect an ideal credit market for sponsors and borrowers. To fully reap the benefits of the market, sponsors and borrowers should look to alternative lenders for financing and consider the advantages of the unitranche structure.

Cheng: The financing environment is still strong enough that an acquirer should be able to get a deal done with pricing and operational flexibility that are good relative to historical standards. However, in light of the current market environment, pushing the envelope on everything might not be the best approach to take. Regardless of how aggressive a covenant package is sought, acquirers should not be surprised to see a push for investor friendly changes with respect to terms such as pricing, call protection and incremental loan MFN protection.

Yamarone: Borrowers should take advantage of the competitive dynamic between lenders and explore capital alternatives from both traditional banks and alternative investors. Companies from all industries and sizes are able to tap various pools of capital to finance acquisitions and provide additional dry powder for growth. A competitive process enables the borrower to achieve a debt structure with maximum operational flexibility and minimal call protection.

Moll: It is general knowledge that today's market conditions offer friendlier financing conditions than in past years. Therefore, even if the acquirer has plenty of equity on hand for a planned transaction, we advise acquirers to seek higher debt to equity ratios. The interest rates currently seen are historically low and companies should seize this opportunity not least because of the potential profits of using leverage. ■