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2014: a very good year

Luc Defferrard, **Lukas Wyss** and **Maurus Winzap** of **Walder Wyss** offer an overview of Swiss acquisition finance after a healthy 12 months in the market

The market for acquisition finance was very active during 2014 in Switzerland. The KPMG M&A Report Switzerland 2014 states:

With an impressive number of large, strategically driven deals, 2014 was an extremely active M&A year both in Switzerland and globally. The total volume of transactions with Swiss involvement sky-rocketed by $155 billion to reach a whopping total of $188 billion. Yet the M&A year was not just characterised by large landmark deals. The number of transactions also increased by an impressive 33% year on year which shows that M&A represent a vital, central element of corporate strategies in today's world.

These figures include transactions where either the bidder or the target (or both) are based in Switzerland.

As in other jurisdictions, acquisitions in Switzerland are either financed through equity or debt or a mixture, depending on the finance needs and the balance sheet structure of the bidder. Equity instruments may include hybrid instruments and any kind of subordinated debt. Whilst strategic investors possibly do not want to or have to leverage up the acquisition, private equity investors obviously have a different approach.

Debt packages do vary, depending on volume and leverage required.

Two different worlds

In smaller Swiss domestic transactions with less leverage, debt packages typically consist of senior debt only, possibly completed by a target level (revolving) facility, if existing target level debt needs to be refinanced. These acquisition financings are most often provided to Swiss acquisition vehicles by Swiss banks, including Swiss Cantonal banks and smaller financial institutions. Typically, these banks do not look at syndicating the debt with other investors. Rather, these banks tend to hold the debt position on their balance sheet until term. The relationship between these banks and the sponsors or borrowers are very much driven by relationships and cross-selling opportunities. The process and documentation is less standardised, and for these transactions, the funding market is mostly limited to Switzerland. This usually limits the volume of such transactions.

> **The total volume of transactions with Swiss involvement sky-rocketed by $155 billion**

In larger Swiss transactions, international financing markets (including debt capital markets) need to be taped. Therefore, structures follow international standards and the debt package will typically be supplemented by first and second lien financing as well as mezzanine financing. For such transactions, the structures most often include: (i) the placement of acquisition term-loan tranches with institutional investors (rather than just banks); and (ii) the issuance of high-yield bonds. The process and documentation follows international market standards.

Tax considerations

10/20 Non Bank Rules

The Swiss Non-Bank Rules comprise the Swiss 10 Non-Bank Rule and the Swiss 20 Non-Bank Rule. According to the Swiss 10 Non-Bank Rule, a finance transaction of a Swiss borrower or issuer qualifies as 'collective fundraising' (similar to a bond) if a lending syndicate consists of more than 10 non-bank lenders. If that is the case, the Swiss 10 Non-Bank Rule is breached. Bond transactions by Swiss issuers are typically per se not compliant with the Swiss 10 Non-Bank Rule. Under the Swiss 20 Non-Bank Rule, it is tested whether or not a Swiss borrower or issuer has, on aggregate, more than 20 non-bank creditors. If that is the case, the Swiss 20 Non-Bank rule is breached.

Breach of the Swiss Non-Bank Rules results in Swiss withholding taxes at 35% on interest payments. On this basis, interest payments on bonds issued by Swiss issuers are generally subject to 35% Swiss withholding tax. Such taxes would have to be withheld by the Swiss obligor and are generally easily (but, depending on any applicable double taxation treaty, may not be fully) recoverable by Swiss lenders and investors.

When structuring a syndicated finance transaction involving Swiss borrowers to comply with the Non-Bank Rules, the usual approach is to limit the number of non-banks (investors) to 10. This approach is also pursued in small Swiss domestic acquisition finance transactions, because the banks involved are not looking at syndicating the debt and typically agree to the related transfer restrictions contained in the debt documents.

In larger Swiss leveraged acquisition finance transactions, this approach is obviously not feasible, given the syndication of term loan tranches or placement of notes. Accordingly, funds under these transactions may not be raised by a Swiss borrower or issuer, but rather through one or several top-tier vehicles incorporated abroad in a jurisdiction which has a beneficial double tax treaty with Switzerland (for the purposes of up-streaming dividends without withholding). A foreign vehicle may either act as acquisition vehicle or may itself set up a Swiss acquisition vehicle, if that is beneficial to the structure for other (tax) structural reasons. Given the generally beneficial double tax treaty between Switzerland and Luxembourg, structures often involve multi-level acquisition vehicles incorporated in Luxembourg.

If funds raised by a non-Swiss borrower or issuer are on-lent within the group to a Swiss target company (or to a Swiss acquisition vehicle), this may be regarded as circumvention by the Swiss Federal Tax Administration (SFTA). This is especially relevant if the Swiss target company or a potential Swiss acquisition vehicle guarantees and secures the acquisition financing. However, the SFTA has previously considered and approved structures that have included these structural elements by way of binding tax rulings. Nevertheless, the process must be carefully structured, with consideration of the time needed for the tax rulings, in particular when a Swiss acquisition vehicle is used (because the proceeds of the financing will by and large be on lent to a Swiss vehicle).

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Around 200 people work at Walder Wyss. The team of 130 legal experts – all of whom are highly qualified multilingual professionals with international experience – is augmented by around 70 employees working in support functions.

Walder Wyss began early to specialise in selected commercial sectors and we are now known for our profound knowledge of our clients' specific businesses. Walder Wyss is active in national and international professional organisations and maintains established business relationships with partner law firms in other countries.

Walder Wyss was established in 1972 in Zurich and has grown steadily since inception. Walder Wyss has also offices in Berne since 2009, in Lugano since 2013 and in Basel since 2014.

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If the transaction includes a (revolving) working capital facility lent directly to the (Swiss) target companies, compliance with the Non-Bank Rules can only be achieved by limiting the number of non-banks to 10. To ensure that the acquisition debt portion of the financing (which typically has more than 10 non-banks as lenders or noteholders) does not affect the working capital facility, it is key to structure these facilities in a manner which ensures that they qualify as separate financings under Non-Bank Rules. Similarly, loss sharing provisions and similar (equalisation) provisions contained in inter-creditor arrangements must also be carefully structured or confirmed by the SFTA (by way of tax ruling) against the Swiss Non-Bank Rules.

The legislative process for amending the Swiss withholding tax regime is, at the time of writing, ongoing. On December 17 2014, the Swiss Federal Council issued draft withholding tax legislation, which would include a change from the current issuer withholding tax system to a paying agent tax system. If enacted, such legislation may require a paying agent (such as banks) in Switzerland, to deduct Swiss withholding tax at a rate of 35%, subject to certain exceptions, on interest paid to or credited to an account of a beneficiary resident in Switzerland. It remains to be seen what the impact of the proposed changes will be on (i) the 10/20 Non-Bank Rules in general, and on (ii) the structuring of leveraged acquisitions in Switzerland more specifically.

Deductibility of interest expenses

Under Swiss tax law, interest incurred at the level of the acquisition vehicle is not available for set-off against income generated at the Swiss target company level, for income tax purposes. This is because there is generally no tax consolidation under Swiss tax law (either in Swiss domestic or cross-border situations). However, there are means to (indirectly) push down the acquisition debt portion, particularly if the existing debt can be refinanced at target level. For the purposes of the Swiss Non-Bank Rules, this would need to be structured as a downstream loan from the acquisition vehicle to the target level (or by refinancing the existing debt at the target level, though that would result in a limitation of the number of non-banks to 10 for that portion of the debt). However, given the on-lending of the proceeds of the acquisition debt, the Swiss Non-Bank Rules would have to be carefully addressed.

Certain issues are not clear cut, in particular the arm's length analysis

Alternatively, an (indirect) push down can be achieved by way of an equity-to-debt swap, where equity (freely distributable reserves or even share capital that can be reduced) is distributed (but not actually paid out) and then converted into a downstream loan. In recent transactions, additional push down of debt potential has been created by some post acquisition restructuring steps (such as group internal sales of assets generating additional earnings and respective debt capacity).

If such a push down can be achieved, some of the interest incurred on the acquisition debt can be brought to the target company level and may become available for set-off against income generated at the target level. Further, the security package structure can be improved in connection with such a push down.

Security

Standard security package at closing

Standard security packages at the closing of acquisition financing transactions involving Swiss target companies typically include: (i) share security over the top Swiss target company; (ii) security over claims and rights under the share purchase agreement, due diligence reports and insurances (such as M&A insurances); and, (iii) bank accounts.

In larger transactions, there is typically a lack of access to the target company and accordingly, target level security will be provided post-closing. However, if possible from a process perspective and if necessary structures and elements are already in place (such as up- and cross-stream mitigants, and a change of board), there is nothing from a Swiss law perspective that would prevent banks and investors from getting target level security at closing.

The security provided by the acquisition vehicle can be entered into and perfected pre-closing, except for the share pledge, which can only be perfected upon the closing of the transaction, immediately after the acquisition of the shares by the acquisition vehicle. From a Swiss point of view, there is nothing that would make it overly burdensome or impossible to perfect the security as soon as the transaction is completed or closed. However, some items (such as the amendment of articles of association or notices) will have to become post-closing items; but, as described above, this does not prevent the perfection of the security interest as such.

Standard target level security package

In addition, security is typically granted by the Swiss target companies. The target-level security package is similar to fully-fledged security packages in other jurisdictions and may include security over: (i) shares in group companies; (ii) trade receivables; (iii) intercompany receivables; (iv) insurance receivables; (v) bank accounts; (vi) intellectual property; and, (vii) real estate.

It is very difficult, if not impossible, to get security over movable assets (such as inventory and equipment) due to strict depossession requirements under Swiss law. There are ways to structure around this (for instance through asset special purpose vehicle structures), but this is only feasible in a scenario where there is a particular focus on certain assets held by the Swiss target companies.

With regard to security over real estate, there is one important tax point that needs to be considered. Interest payments to non-Swiss resident creditors of loans secured by Swiss real estate are subject to withholding tax at source, unless the lender is located in a jurisdiction that benefits from a double tax treaty with Switzerland providing for a zero rate. Accordingly, in case of a Swiss borrower or issuer, it must be ensured that only Swiss treaty lenders will be secured by real property in order to avoid the risk of withholding tax applying to interest payments. This might result in complex unbalanced distributions of proceeds that might be quite challenging for a transaction. The simple compensation through sharing of payments provisions and equalisiation provisions is likely to be regarded as circumvention.

In case of a foreign borrower (such as a foreign acquisition vehicle), the issue basically remains the same, but one should consider applying for an exemption through a tax ruling application. Whilst such positive tax rulings have recently been obtained in a few Cantons, the process of getting such ruling in other Cantons may be quite lengthy and therefore costly (and the outcome uncertain). Without a satisfactory tax ruling, real estate located in Switzerland cannot be granted as security due to risk of potential withholding tax on interests payments.

Unless there is some co-operation from the seller to start preparing target-level security before closing (and depending on exact release mechanics from existing financings), target-level security might only be available post-closing. Further, it is usually agreed that target-level security may be completed as a subsequent condition.

Up- and cross-stream security

Standard up-stream limitations will have to apply to Swiss target level guarantees and security. These limitations may affect the security substantially, particularly in situations of financial distress. This is another reason to carefully consider whether a Swiss acquisition vehicle is feasible, because the share pledge over the top Swiss target company would also be affected by Swiss financial assistance rules, whilst limitations for Luxembourg vehicles seem to be less restrictive.

A recent Swiss Federal Supreme Court decision rendered in connection with up-stream loans in the framework of a cash pool shows that up- and cross-stream limitations are still a moving target. Moreover, certain issues are not clear cut, in particular the arm's length analysis.

However, if structured properly and if using all available mitigants, such limitations are generally accepted by investors and lenders.

If the structure also includes a down-stream loan from the acquisition vehicle to the Swiss target companies (often used for tax purposes as a push down of debt and for the repatriation of the cash flows) the Swiss target company can provide (unrestricted) security to secure such down-stream loan, because it would secure its own debt rather than parent debt. This would therefore not qualify as up-stream security. The acquisition vehicle in turn may provide security over the downstream loan, along with the (unrestricted) security package securing such downstream loan. From a Swiss corporate law perspective, there are good chances that upstream limitations would not apply to that security structure. However, such a security structure should be discussed with the SFTA in the light of the Swiss Non-Bank Rules.

Debt commitment letters

In smaller Swiss domestic acquisition finance transactions, the requirement for debt commitment letters was relatively relaxed and sellers typically accepted quite broad condition precedents in the commitment letters. Sometimes, even a highly confident style letter or a non-binding (but fully negotiated) term sheet was acceptable. However, there is a tendency to apply more strict standards and sellers are increasingly requesting more extensive and narrower debt commitment letters.

In larger international transactions, debt commitment letters follow international standards so that international market expectations are met. Therefore, extended long form debt commitment letters are used to which, sometimes, even fully negotiated documentation is attached.

Financing of public takeovers

Certain funds

In the context of Swiss public takeovers, certain fund requirements must be met.

Certain funds must be available on the launch of the offer and availability must be confirmed by a special auditor. It is, however, prudent for a bidder to ensure certain funds upon pre-announcement of the offer, as the bidder must proceed with the offer within six weeks, once the pre-announcement has been published; the offer, however, is typically launched fairly quickly after pre-announcement for strategic reasons and, therefore, financing will be in place upon pre-announcement anway..

Further, the offer prospectus must provide for financing details and confirmation from the special auditor.

Typically, only the very basic terms of the financing must be disclosed in the offer prospectus and it is not necessary to disclose details on pricing and fees and similar commercial terms.

Given the specific funds requirements, the financing may only contain limited condition precedents. The Swiss takeover board has issued guidelines in this respect. (Supervisory authorities or courts are not bound by such guidelines, but the guidelines are still generally considered an important indication) and according to these, the following conditions are generally acceptable: conditions that match conditions contained in the offer; material legal conditions relating to the bidder, such as status, power, authority and change of control; conditions relating to the validity of finance documents, in particular security documents and the creation of security ; conditions relating to material breaches of agreements by the bidder, such as pari passu, negative pledge, no merger, non-payment; and, material adverse changes in relation to the bidder.

However, market and target MAC clauses are not generally permitted.

Structural challenges

Under Swiss takeover and corporate law, a bidder will have to reach an acceptance level of 90% to be able to pursue a forced squeeze-out after the closing of the public takeover. However, a bidder has only limited flexibility in introducing acceptance thresholds into the offer and any acceptance threshold of more than two-thirds will require approval from the Swiss takeover board. Although there are good chances that this threshold can be pushed to 75%, it is unlikely that the takeover board will accept any threshold above 75%.

Sellers are increasingly requesting more extensive and narrower debt commitment letters

Accordingly, the financing must be available and committed even though it is not absolutely certain that the bidder will ever get 100% control over the target. This situation is challenging from a financing perspective and there are two approaches to resolve it. First, one could simply apply a more conservative overall leverage; however, this does affect the overall economics of the transaction considerably and will ultimately influence the bid price and the chances of the tender offer being successful. Alternatively, two different financing structures could be prepared.

If the bidder does not (yet) have 100% control over the Swiss target company, access to target-level cash flows may be limited because: (i) it is difficult to structure up-stream loans to a majority shareholders in a manner compliant with the principle of equal treatment of shareholders; and, (ii) any leakage of dividends to minority shareholders should be avoided. Further, target level security is not available in the interim period because that would again raise questions under the principle of equal treatment of shareholders.

Outlook

We expect a very active market for acquisition finance in 2015. The most important expected change of law that will affect lending in Switzerland generally (and in particular leveraged acquisition finance transactions) relates to Swiss withholding tax. As mentioned, it remains to be seen what the exact impact of the proposed changes will be.

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Born in 1965, Luc Defferrard was educated at the Geneva University and was registered as attorney-at-law with the Geneva Bar Registry in 1990. Prior to joining Walder Wyss, he worked for seven years with UBS in Geneva, Zurich and New York as client manager and project manager in corporate and structured finance where he developed the bank's syndicated loans offer to clients in the French part of Switzerland. Defferrard lectures regularly at universities in private equity and venture capital legal matters.

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