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Leveraged Finance in France: Recent Developments

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French Market was very active in 2011

2011 French Private Equity Market

Number of Transactions

- 34 Transactions > M€ 100
- 13 Transactions > M€ 500

Latham & Watkins Market Share

- 22 Transactions > M€ 100 (65%)
- 4 Transactions > M€ 500 (30%)

Source : *Magazine des Affaires*, January 2012



#1

Private Equity

Legal 500 2011, Chambers 2011

2011 Finance
Trophées d'Or

- Acquisition Finance
- LBO Upper Mid & Large

*Décideurs Stratégie Finance Droit
2011 Awards - France*

High Yield in French LBO Transactions

- High yield/bridge-to-HY has been increasingly used in a number of “French” leveraged financing transactions
 - Finance initial acquisition
 - Refinance existing financing (in whole or in part)
 - Finance a leveraged recap
- Structures used have varied



High Yield in French LBO Transactions

- HY co-existing with senior financing
 - HY structurally and contractually subordinated to senior financing
 - Picard (September 2010)
 - Geo Travel (Go Voyages/Opodo/e-Dreams) (April 2011)
 - Spie (April 2012 refinancing of Summer 2011 bridge-to-HY)
- Super senior RCF+ HY structures
 - HY issuances required to (re)finance long-term financing needs; combined with smaller senior RCF piece financing working capital requirements
 - most security shared between HY and RCF
 - decision to enforce shared security belongs both to RCF and HY
 - marshalling clauses
 - Very popular in French market early 2011 - number of transactions started but only Labco (May 2011) happened by time market closed
 - Likely to be used to help refinance “wall of debt” - watch this space in 2012

High Yield in French LBO Transactions

- HY used to finance a new senior tranche
 - Repay/replace part of existing senior bank financing
 - Europcar (2010) - PagesJaunes (May 2011) – Numéricable (February 2012)
 - Requires existing Financing Parties authorization
 - Senior Lender waiver
 - Use of Permitted Facility Change mechanism
 - HY issuer *qua* Senior Lender not given all rights granted to "normal" senior lenders
 - Voting undertaking
 - Covenant agreement

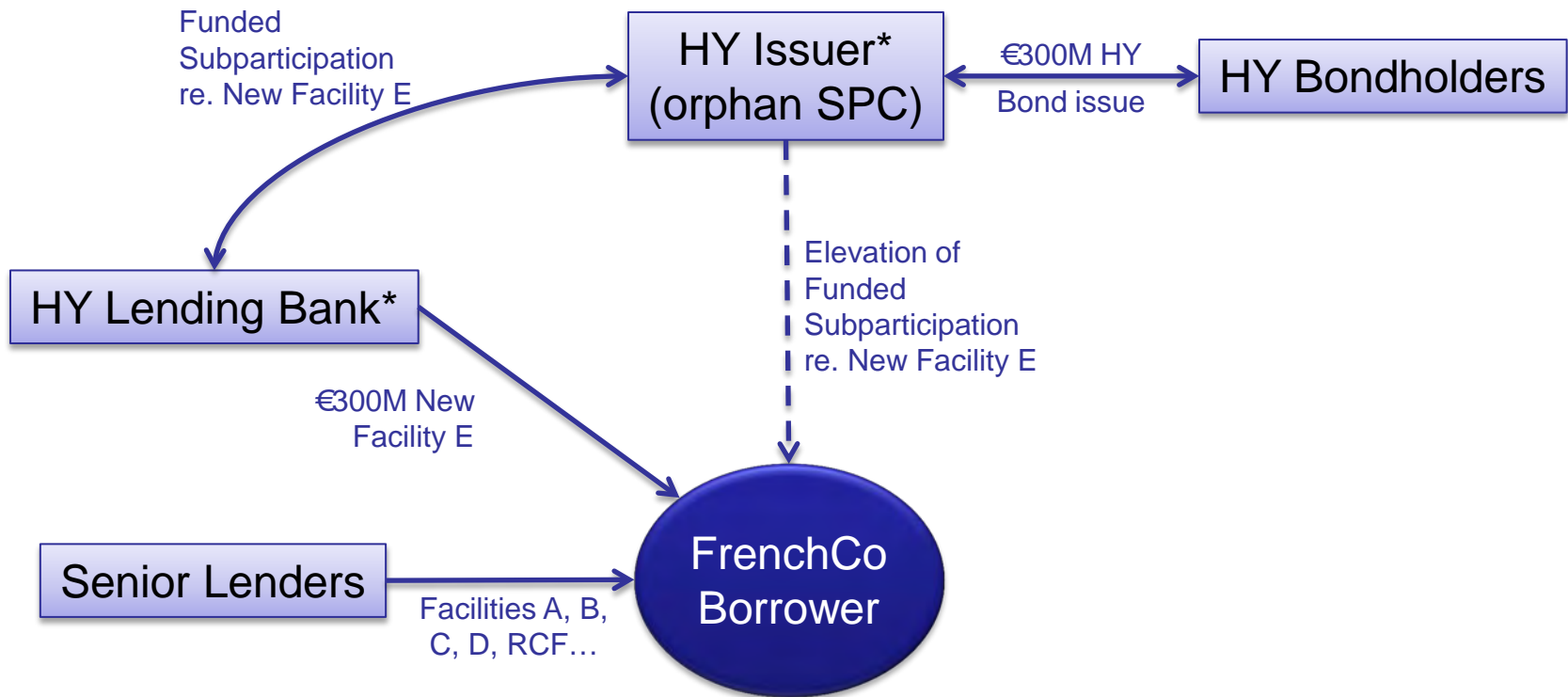
French Banking Monopoly Issues

Can HY issuer be lender to Obligor Group?

- Only a financial institution which is licensed to lend in France (or authorised to lend in France using "European Passport") may extend a loan in France to a French borrower
- Exceptions:
 - Intra-group loans fall outside prohibition
 - Requires issuer to be part of Group
 - Risk on bankruptcy-remoteness analysis
 - French banking monopoly rules are territorial in reach
 - Purchase (outside France) by HY issuer of direct participation in new senior tranche after it has been extended
 - Sub-participation which is then elevated or forward sale agreement (in either case, funded with HY proceeds)
 - Managing risk of non-elevation of Sub-participation

French Banking Monopoly Issues

HY issuer becoming lender to Obligor Group

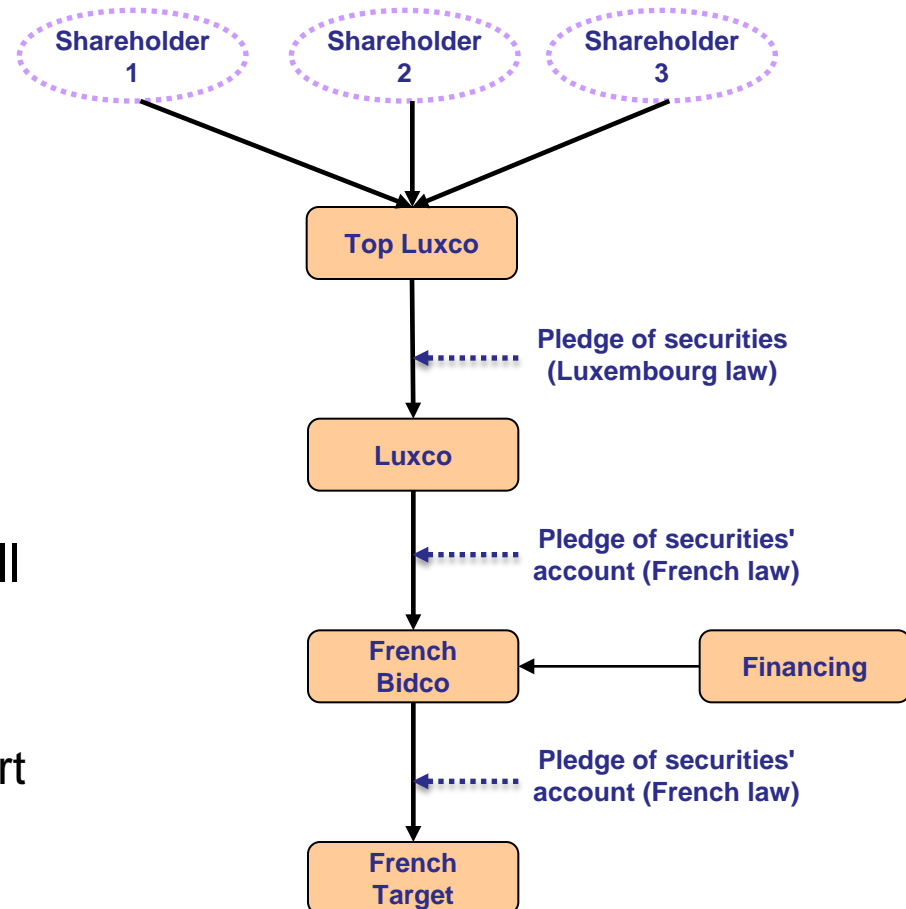


*acting from outside France

Double Luxco Structures in France

Double Luxco ownership/security structure

- Almost all large and mid-market LBO financings centered on France since 2010 structured to include "Double Luxco" ownership and security structure
- Triple or quadruple Luxco structures in transactions required to ensure structural subordination of high yield debt providers (ex. Picard, Spie)
- No Double Luxco structure in small or s'mid-cap
 - Implementation of Double Luxco structure has cost which transactions cannot always support
 - FCPR vehicles through which certain Sponsors act cannot be made subject to *sauvegarde*



Double Luxco Structures in France

Article 5 of EC Insolvency Regulations

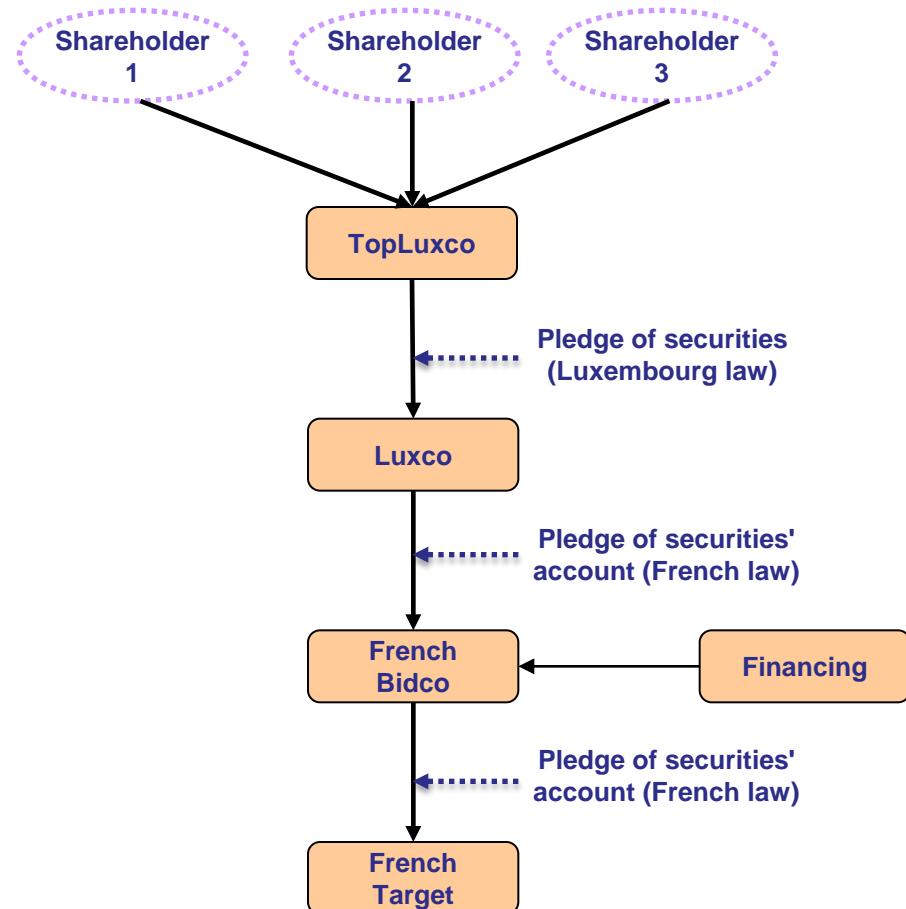
- Article 5 of EC Insolvency Regulations of 29 May 2000
 - Share pledge granted by Top Luxco over shares of Luxco constitutes rights *in rem*
 - "*right to dispose of assets or have them disposed of and to obtain satisfaction from proceeds of or income from those assets, in particular by virtue of a lien or a mortgage*" (Article 5 paragraph 2(a))
 - rights *in rem* will not be affected by French insolvency proceedings to extent that they are "*situated within territory of another Member State at time of opening of proceedings*" (Article 5, paragraph 1)



Double Luxco Structures in France

Effect of insolvency on Double Luxco Structure

- Opening of French insolvency proceedings against Luxco(*) stays enforcement of French law-governed pledge granted by Luxco over shares of French Bidco
- Opening of French insolvency proceedings against TopLuxco(*) does not stay enforcement of Luxembourg law-governed pledge granted by TopLuxco over shares of Luxco
- Luxembourg insolvency proceeding in respect of TopLuxco does not stay enforcement of TopLuxco share pledge



(*) assuming COMI in France

Double Luxco Structures in France

Primary objectives of enhanced security package

- Not designed to prevent or circumvent application of French insolvency laws (including *sauvegarde* regime)
- Enhance ability of Secured Parties to enforce security package and take control of Luxco and (indirectly) French Bidco, notwithstanding that French Bidco or Luxcos may be in safeguard proceedings
- Deter Sponsors from using *threat* of hostile safeguard proceedings to increase their bargaining position as part of restructuring negotiations



Double Luxco Structures in France

Enforcement of Luxembourg security package

- Ensure that assets subject to security are "situated" within Luxembourg
 - Luxco should take legal form of S.A. (*société anonyme*) or S.C.A (*société en commandite par actions*)
 - Shares of S.à.r.L. (*société à responsabilité limitée*) have legal nature of a receivable (debated)
 - EC Insolvency Regulations provides that enforcement of rights over receivables is subject to laws of COMI of debtor and not those of place where assets are situated
 - Luxco pledged shares in bearer form or on register held in Luxembourg through a trustee
 - Avoid challenge as to whether shares of Luxco2 are located in Luxembourg

Double Luxco Structures in France

Intercreditor principles



- Although certain issues are broadly settled, many still require to be negotiated from transaction to transaction
 - Negotiate and include in Commitment Documents an “Intercreditor Principles Term Sheet”
 - Agreed Security Principles will also specify specially tailored basis upon which security interests which are part of Double Luxco structure will be drafted and enforced

Double Luxco Structures in France

Conditions for enforcement of Luxco Share Pledge

- No need to accelerate underlying debt guaranteed by Luxcos to allow enforcement of Luxembourg law share pledges
- Documentation will contractually limit right to enforce Double Luxco security package to certain specified situations
 - Acceleration of any amount following payment default
 - Acceleration of minimum percentage of principal of debt, or amount of principal as compared with value of pledged shares
 - Adverse Corporate Decisions / Change of Control / Sale
- "Acceleration" effective under Luxembourg law irrespective of effect of insolvency proceedings which may stay etc. effect of notice

Double Luxco Structures in France

Structure protection: Adverse Corporate Decisions

- Right to enforce Luxco security if occurrence of Adverse Corporate Decisions whereby Luxco would lose right to appoint management of relevant FrenchCos
 - Protect capacity to terminate hostile safeguard proceedings
- Also includes
 - Change of by-laws of Luxcos without consent of Agent
 - Change of corporate form
 - Change of Luxcos by-laws which adversely affects ability of Finance Parties to enforce their rights under Finance Documents
 - Change of COMI of Luxcos and FrenchCos



Double Luxco Structures in France

Flexibility of enforcement of Lux share pledges

- Luxembourg law allows variety of methods of enforcement
 - Sale by public auction
 - Court-ordered foreclosure: transfer of title to pledgee at price determined by court-appointed expert (“*attribution judiciaire*”)
 - Private foreclosure: appropriation at price set further to application of agreed valuation method (“*pacte comissoire*”)
 - Private sale on arms'-length terms (“*conditions commerciales normales*”)
- French law broadly allows same methods of enforcement of security
 - Except for private sale



Double Luxco Structures in France

Private sale in enforcement of Lux share pledges

- Luxembourg law allows enforcement through private sale on arms' length terms
 - Is Sponsor able to exclude this method of enforcement?
 - May Sponsor make private sale subject to additional conditions which ensure enforcing Lenders obtain a fair price?
- Subordinated Creditors need to ensure that private sale is made subject to conditions which ensure fair price is obtained
 - Fairness opinion from independent internationally recognised investment bank
 - Right to match of Subordinated Creditors on same terms and conditions as third-party purchaser (except on certain funds basis)
 - Ensure that any protection given to Subordinated Creditors applies to resale following initial enforcement through foreclosure in favour of Lender Newco
- Right to enforce through private sale generally disallowed when subordinated financing is HY

Double Luxco Structures in France

Senior Lenders' Shareholding Costs

- Enforcement through foreclosure by Senior Lenders will lead them to exchanging all or part of their senior lender (financiers') rights and claims for equity
- To extent Senior Lenders taking shareholders' risk, generally require specific compensation (Shareholding Costs) for their Impaired Liabilities, i.e.
 - Lender rights exchanged for equity
 - Loans written-off or waived post-enforcement
- Shareholding Costs
 - Usually come after Senior interest (including on Impaired Liabilities)
 - Sometimes include Senior Interest (including on Impaired Liabilities)
 - Sometimes divided between
 - Senior Shareholding Costs (remuneration floor)
 - (lower down in waterfall) Junior Shareholding Costs (additional remuneration, subject to pre-agreed cap)
 - Situations are numerous and still hotly negotiated from deal to deal

Double Luxco Structures in France

Sponsor/Security Providers' Recourse Rights

- Sponsor SPC (Top Luxco, Luxco, etc.) which grants security *in rem* over shares in its subsidiary has a right of recourse against primary obligor whose obligations it secures following enforcement of such security
- Recourse Right will be assigned at closing to Senior Creditors for nominal amount + additional amount (payable later in ICA waterfall)
 - Assumes that enforcement/post-foreclosure resale allows payment in their entirety of costs, Senior Creditors' entitlement, any Subordinated Financing Parties' entitlement, etc... and there is still something left
 - Senior Creditors have no obligation to pay any amounts with respect to Assigned Recourse Rights in excess of what actually available after Senior Liabilities have been discharged
 - At very bottom of ICA waterfall
- Entitlement to additional amount may vary (decrease) on a ratchet basis with passage of time
 - Timing / percentages negotiated on a case-by-case basis
 - Depends in particular on size of Sponsor's initial equity cheque
 - Arguably no decrease if Shareholding Cost concept incorporated

Double Luxco Structures in France

Payment of *soulte* upon foreclosure

- If value of foreclosed shares exceeds claim for which foreclosure is sought, pledgee required to pay pledgor such excess amount (*soulte*)
 - How likely is issue to arise in practice ?
- *Soulte* payable when foreclosing Lenders have had their claim discharged as a matter of law, but not financially
 - Luxembourg law allows waiver/indefinite deferral of payment of "*soulte*"
 - French law does not allow waiver/indefinite deferral
 - Enforcing creditors have obligation to pay *soulte* to relevant pledgor
 - In practice waiver for 6-12 months following foreclosure
 - But Intercreditor Agreement provides that
 - An amount equal to *soulte* paid or payable by Senior Lenders is paid to them out of enforcement proceeds at very top of waterfall
 - Any *soulte* actually paid to Security Providers (i.e. Top Luxco, etc.) is required to be turned-over to Security Agent and reapplied in ICA waterfall

Double Dutch Structures ?

- Double Dutch BV structure may broadly work like Double Luxco
 - Pledge over shares in Dutch HoldBV granted by Dutch TopBV can be enforced even if Dutch TopBV subject to Dutch insolvency proceedings
 - Shares in Dutch BV should be deemed assets (not receivables) located in NL for purposes of EC Insolvency Regulations
 - Even if determined that Dutch TopBV's COMI is in France and Dutch TopBV made subject to French safeguard/insolvency proceedings, enforcement should not be stayed in NL
 - Voting rights arrangement substantially similar to those customary in Double Luxco structures could be included in Dutch law share pledge/by-laws
- *Caveat.*
 - Dutch law requires payment default before enforcement of security interests
 - Enforcement through private sale possible only with consent of pledgor obtained after enforcement has become possible
 - Credit-bid arguably possible but no precedents of same
 - No legal precedent of Double Dutcho structures in NL practice

Management of Security Package

No proper French Security Agent mechanism

- Management of French security package in large transactions can be complicated
 - No concept of “trust” or “Security Trustee” under French law to enable Security being granted to single entity which holds it on behalf of fluctuating pool of beneficiaries
 - Recent creation of French “security agent” mechanism (article 2328-1 French Civil Code) ill-drafted / not used by practitioners
- Certain common types of French security interests (e.g. share pledges) require each beneficiary be listed and accurately identified
 - No problem if security is granted at time financing is extended and financing parties limited in number/readily identifiable
 - Transfer of secured claims includes with it (as matter of French law) related security interests
 - Makes granting additional security during life of financing to large pool of Lenders/unidentifiable group of Noteholders cumbersome/impossible

Management of Security Package Security Agent and Parallel Debt – *Belvedere*

- September 2011 Supreme Court decision in *Belvedere* litigation has broadly recognized rights of security trustees and efficacy of foreign parallel debt mechanisms
 - Trustee validly appointed under trust governed by NY law could validly be regarded as creditor in safeguard proceedings opened in France
 - Concept of parallel debt governed by NY law “not incompatible with French law concept of international public policy”
 - Rights of Security Agent as parallel debt creditor (appointed in Intercreditor Agreement) recognized in safeguard proceedings in France
- *Caveat*: inadvisable to use these mechanisms in “Franco-French” transactions where less justification for using English/NY law governed documentation

Unitranche Financings

- Single tranche of financing at "blended" rate
 - Give overall return similar to that which would be obtained on Facility B + Mezzanine financing
- Product offered principally by Mezzaners or Hedge Funds (non-regulated financial institutions)
 - needs to be structured as a bond issue (*obligations*)
- Appropriateness
 - Bank financing not readily available
 - Obligor group has large Capex etc. requirements
 - Give flexibility (bullet repayment, no ECF sweep, no clean down)



Facility C/Second Lien Revisited

- Some transactions have seen incorporation of a new type Facility C
 - Shares security *pari passu* with "super" Senior Facilities
 - *Pari passu* in repayment rights with other Senior Facilities, except in event of enforcement of security where rank after
 - Inspired by Super Senior RCF/HY allocation of rights
 - but Facility C is proportionately smaller than HY would be
 - Introduced sometimes post-signing or post-closing to reduce "ordinary" senior leverage and facilitate syndication
- On most issues, Facility C treated same as other senior tranches
 - Facilitates intercreditor discussions: separate enforcement rights/standstill, Payment Stop Notice, call option, marshalling?
 - Facility C Lenders require specific protection/separate voting rights
 - Anti-layering, increase in senior margin, postponement of senior repayment date
 - Maximise value in enforcement - right to match if private sale to third-party
 - Retain protective rights *mutatis mutandis* if sale to Lender Newco

Extension of Thin-Cap Regime

Reminder

- Pre-2010, restrictions to tax deductibility of interest borne by FrenchCo applicable solely to “related-party” (affiliate) loans if exceeded 1.5/1 debt-to-equity ratio
 - Relatively favorable rules
- Since 2010, thin-cap’ rules include third-party financings that are guaranteed by:
 - Company related to French borrower; or
 - Third-party whose commitment is in turn secured by company related to French borrower.
- Exceptions include
 - Financings implemented before 2011
 - Refinancing of pre-2011 financing mandatorily required further to change of control

New Thin-Cap Regime Impact on LBOs

- Exceptions include third-party financings exclusively guaranteed by:
 - Security *in rem* over French borrower's shares (or over receivables against latter)
 - Security *in rem* over shares of company holding directly or indirectly French borrower's shares, **provided** holder of pledged shares and French borrower belong to same French tax-consolidated group
- If security package for French borrower exceeds permitted criteria, financing will not fall within exception
- New regime impacts standard LBO financing structures
 - Security providers will grant personal guarantees, security over bank accounts, business, trademarks, etc.
 - Luxco assets will secure obligations of French sub-holding companies
 - Some group members may grant up-stream credit support of French borrower's obligations

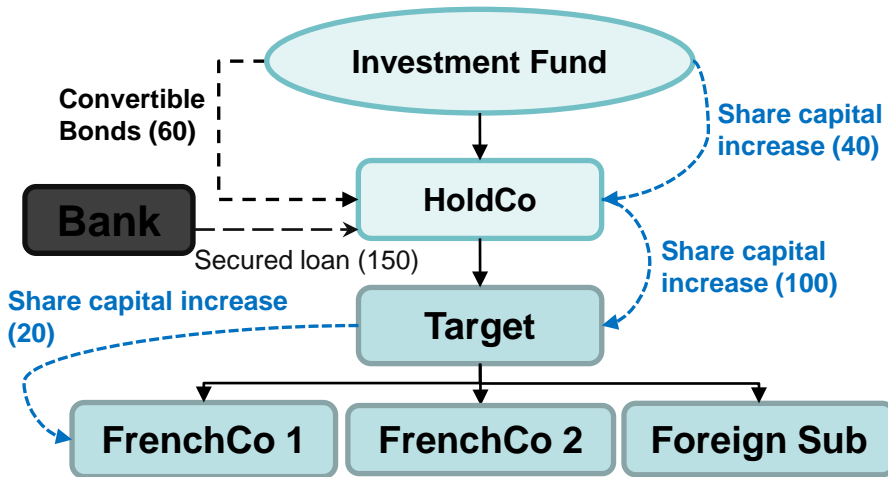
New Thin-Cap Regime Minimising effect

- Possibility to minimise impact of new French thin-cap' regime through allocation of different parts of financing in distinct entities
 - Imperative that structure be justified by *bona fide* economic or legal reasons
 - Otherwise risk of recharacterization on grounds of French abuse of law provisions



New Thin-Cap Regime Structuring Around

Basic acquisition financing structure



- **At level of HoldCo**

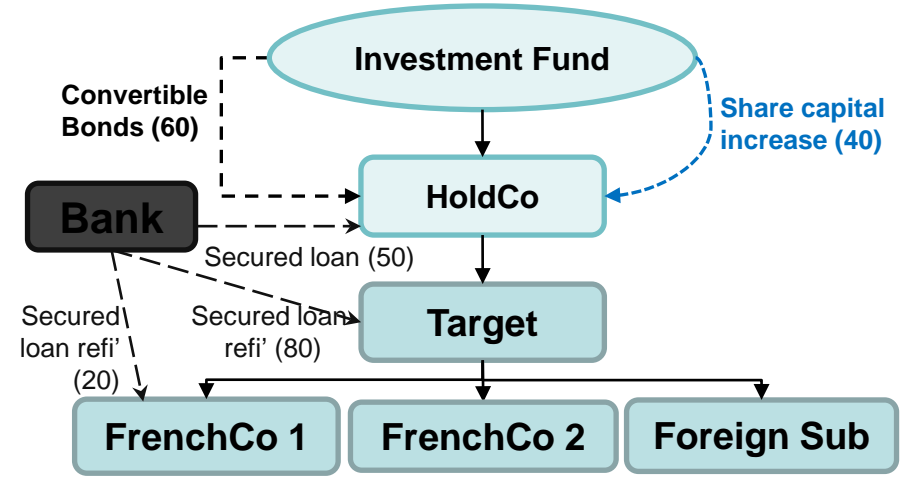
Total debt for thin-cap' purposes: $60 + 150 = 210$

⇒ **HoldCo's debt-to-equity ratio: $210/40 > 1.5$**

⇒ **Portion of interest not deductible**

NB: Before entry into force of extended rules, HoldCo's debt-to-equity ratio would have been equal to 1.5 ($60/40$), enabling full deduction of interest

"Better" acquisition financing structure



- **At level of HoldCo**

Total debt for thin-cap' purposes: $60 + 50 = 110$

⇒ **HoldCo's debt-to-equity ratio: $110/40 > 1.5$**

⇒ **(Lesser) portion of interest not deductible**

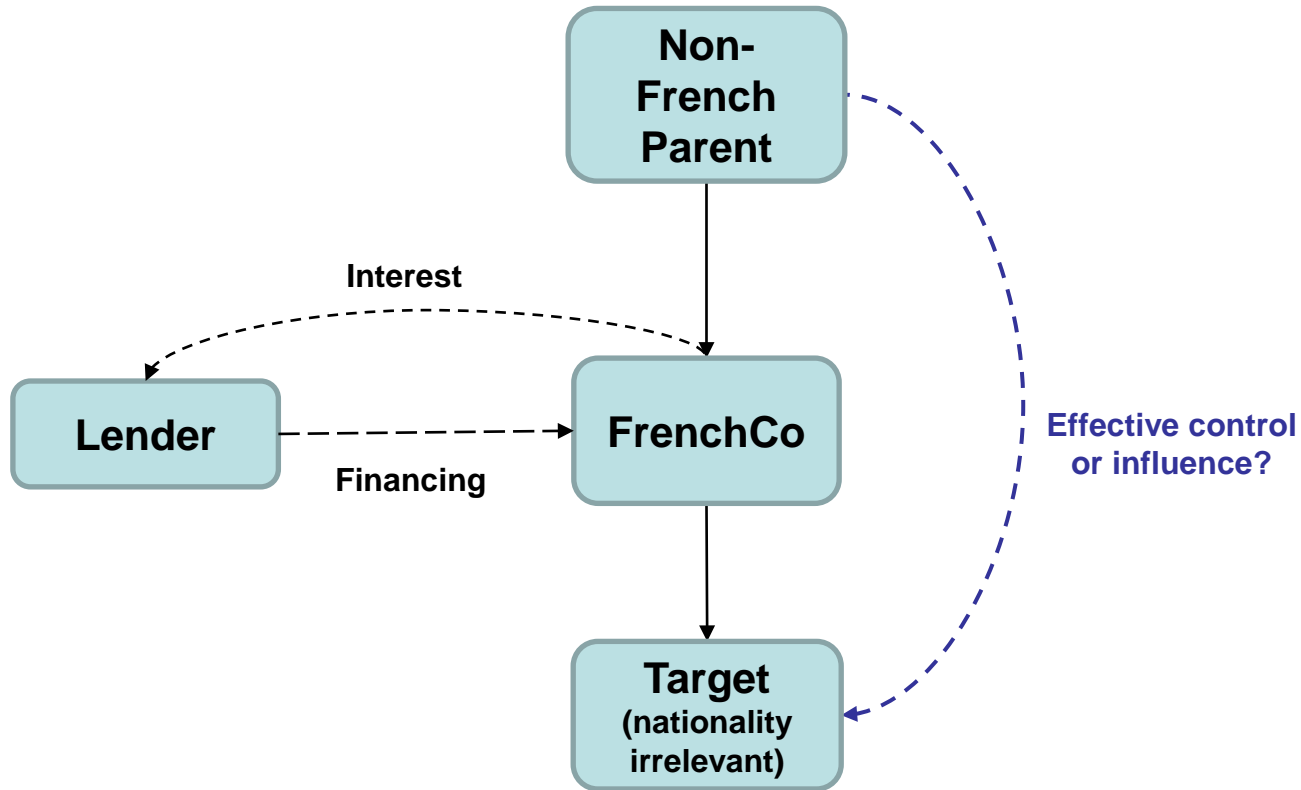
- **At level of Target and FrenchCo 1**

As refinancing of existing debt triggered by change of control, loans do not fall within scope of extended thin-capitalization rules

Amendement Carrez (simplified and focused on LBOs) **Principle**

- Mechanism designed to combat artificial allocation of debt to French corporation in relation to Target not controlled from France
- Presumption of non-tax deductibility of all or part of financial expenses incurred by FrenchCo for acquisition of shares in Target if:
 - (generally) > 5% shareholding in Target
 - Acquisition financed by borrowing
- FrenchCo is required to rebutt presumption
- If rule applies, proportion of financial expenses non-deductible for period of 8 years following acquisition

Amendement Carrez (simplified and focused on LBOs) Example



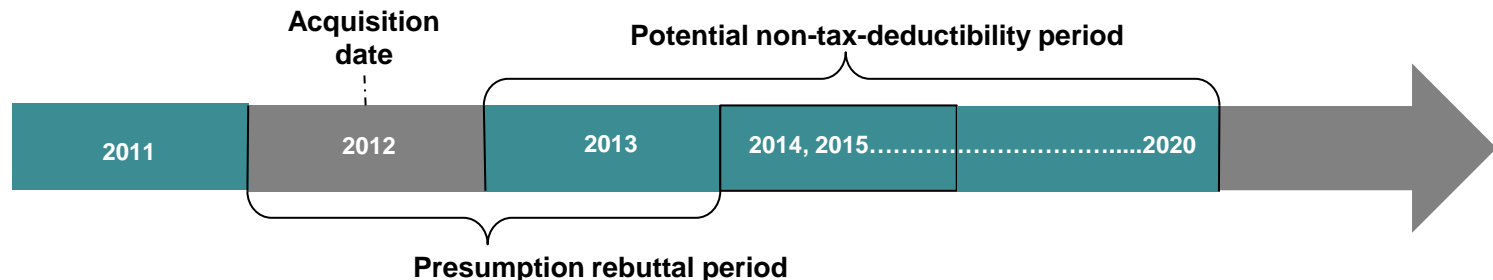
Amendement Carrez (simplified and focused on LBOs)

French borrower as autonomous decision-center

- FrenchCo must show that it constitutes an **autonomous decision-center** (*centre de décision autonome*)
 - Circumstance that FrenchCo newly-created for purposes of acquisition not of itself presumption that not an autonomous decision-center
 - as per draft Tax Administration guidelines
 - FrenchCo took own decision to acquire Target shares or actively involved in such acquisition
 - FrenchCo actively involved in management and control of Target
 - Provide evidence that takes part in shareholders meeting, has personnel, etc.
 - Right of management and control commensurate with size of stake
 - FrenchCo has freedom to sell, pledge, etc. Target shares
 - Restriction on freedom may validly stem from financing agreements
 - Double Luxco security structures may prejudice analysis
 - If overall management and control exercised from abroad (i.e. at Luxco level)

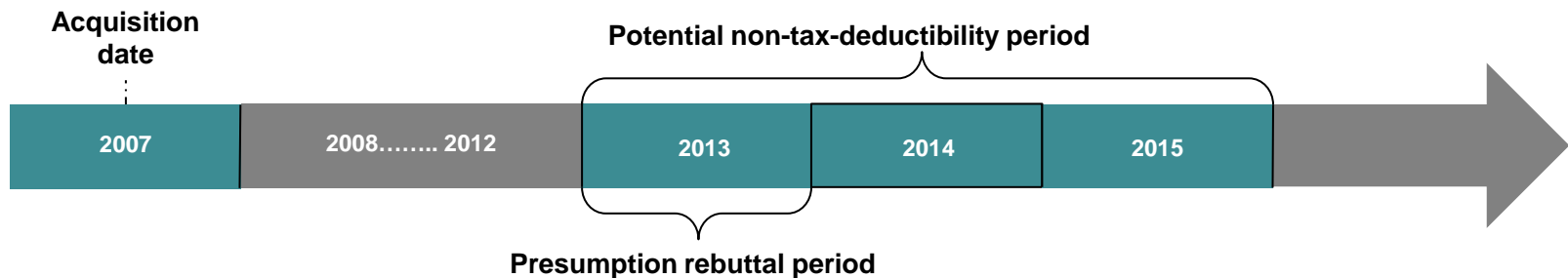
Amendement Carrez (simplified and focused on LBOs) **Application to post-2011 acquisitions**

- Acquisitions of shares as from financial periods commencing in 2012
 - eg. acquisition in March 2012 by FrenchCo with 31 December YE: rebuttal of presumption by reference to events and circumstances 2012-2013, failing which tax-deductibility dis-allowance for 2013-2020 FY



- *Caveat:* any change in loss/acquisition of control after test period has no consequence on tax treatment throughout deductibility dis-allowance period
 - Except sale of shares

- Acquisitions of shares which occurred prior to 2012
 - Because of 8 year disallowance period, look back to acquisitions which occurred in 2005 or later
 - Presumption to be rebutted by reference to circumstances and events in 2013 FY



- *Caveat:* imperative to have existing transactions analysed for any leveraged financing which occurred as from 2005 (included)



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