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# In Practice

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## In Practice: the pitfalls of redemption

In this article the authors examine some of the common pitfalls that arise in connection with the redemption/pay-off of existing facilities in the context of a leveraged buyout transaction.

### THE CONTEXT

Most targets on a leveraged buyout will have in place existing facilities and hedging that will need to be redeemed as part of the transaction. This is particularly the case where a target has been through a previous buyout.

Despite being an apparently relatively small cog in the larger transaction process wheel, the redemption of existing facilities can cause a disproportionate level of disruption to the overall process and if sufficient care and forward planning in relation to the mechanics of redemption are not observed this may result in an unwelcome delay to the completion of a buyout.

This In Practice article considers some of the reasons why issues can arise in connection with the redemption of facilities and the ways in which they can be avoided.

### WHEN IS THE SECURITY RELEASED?

The crucial question that must be answered before anything else is "when will the security attaching to the existing facilities of the target be released?".

It is commonly accepted in the current market that any security granted in favour of an existing lender (the Existing Security) will not be released until that lender has received into its designated bank account (the Redemption Account) all amounts owing to it under the facilities agreement (the Redemption Amount).

That said, borrowers and incoming lenders sometimes seek to make the release of the Existing Security conditional only upon receipt by the existing lender of a SWIFT confirmation demonstrating that payment instructions have been made in respect of payment of the Redemption Amount to the Redemption Account. The benefit of this approach is that the parties do not need to wait for the existing lender to actually receive the Redemption Amount; however since this approach requires the existing lender to take a risk on the underlying banking payment system and funds arriving on the same day as completion, this argument rarely gains traction.

A common misconception (sometimes raised by parties in overseas jurisdictions) is that a Companies House release filing operates to release the relevant charge (as is the case in the US, for instance). This is incorrect and the release will take effect once that document is signed and delivered. Nevertheless it is common to see documents (for instance, share purchase agreements) which show a misunderstanding of English law release mechanics and it may be necessary to explain this point to a purchaser.

### THE "CHICKEN AND EGG" SCENARIO

Working on the basis that the Existing Security cannot be released until the Redemption Amount is actually received by the existing lender, how do the acquisition documents deal with the interaction between formal completion of the acquisition and redemption?

On the one hand, a buyer (and any lender providing acquisition finance to the buyer) will want to ensure that it is buying a target free from the Existing Security. On the other hand, a seller will not want completion of the buyout to be conditional upon redemption and release of the Existing Security, as the Redemption Amount will need to be paid by the buyer.

A neat solution to this "chicken and egg" conundrum is to ensure that the buyer has enough comfort to complete the buyout on the basis that the Existing Security will be released once the buyer has paid the Redemption Amount to the existing lender, which can be achieved using a combination of a deed of release and related pay-off letter.

### THE PAY-OFF LETTER

Following this approach, it will be the seller's obligation under the terms of the relevant acquisition agreement to deliver executed release documents between the existing lender and the existing borrower.

The pay-off letter will, first of all, either include details of the Redemption Amount or set out obligations on the existing lender to provide details of the Redemption Amount within a certain period having received notice of the date on which it is to be paid (the Redemption Date).

Second, the letter (in conjunction with the deed of release) will set out the basis upon which the Existing Security will be released. As discussed above, this is most likely to trigger an automatic release of the Existing Security (and return by the existing lender or their lawyers of the documents of title they are holding subject to the Existing Security) once the existing lender has received the Redemption Amount.

Because the existing lender and borrower will be party to the pay-off letter, a buyer (and any incoming lender) will take comfort that the Existing Security will be automatically released at the point irrevocably agreed in the letter.

### THE DEED OF RELEASE

The deed of release will, as its name suggests, release the Existing Security.

In the interests of ensuring a smooth completion process, it is preferable for the deed of release to be executed by the existing lender prior to completion but employing an "effective date" concept for the formal release of the Existing Security such that the releases will only become effective in accordance with the redemption mechanics set out in the pay-off letter.

The alternative is for the deed of release to be signed by the existing lender prior to completion but left undated; only to be dated by the

existing lender or their lawyers following receipt of the Redemption Amount. Although this option works, it is more cumbersome and will require additional completion mechanics to be built into the process, including agreeing an undertaking from the existing lender's counsel to date and circulate the deed of release at the appropriate time.

## BREAK COSTS

The Redemption Amount will need to include any "Break Costs" that are payable under the terms of the relevant facilities agreement. Break Costs will arise if a loan is repaid on a date that is not the last day of an interest period and are in essence the costs a lender will incur as a result of meeting any matched funding obligations on the interbank market in relation to the loan for the remainder of the interest period.

Break Costs cannot be calculated by a lender until the day on which the loan is repaid. In the context of a leveraged buyout the buyer will need to determine the relevant flow of funds prior to the Redemption Date so it is not practical to wait until that date for the Redemption Amount to be finalised and taken account of in the funds flow.

Accordingly, it is preferable for outgoing lenders to estimate the Break Costs for the Redemption Date. The pay-off letter will then include "true-up" provisions whereby any overpayment of Break Costs will be paid back to the borrower and any underpayment will be paid to the lender, but completion of such a balancing payment will not of itself hold up the release of the Existing Security under the terms of the pay-off letter and deed of release.

## HEDGING CLOSE-OUT

Where a borrower has taken out an interest rate swap to hedge its interest liabilities under a facilities agreement, that swap will need to be closed out as part of the redemption process. Depending on how interest rates have moved, the borrower will either be "in the money" or "out of the money". In either case, the swap will need to be closed out.

A close-out price cannot be determined until the day on which the hedge is actually closed out; albeit the parties will be able to estimate the amount of any applicable close-out price by reference to the mark to market on any given day.

It is possible for the outgoing lender to take account of the close-out amount (if any) in the Redemption Amount; however the downside of this is that the Redemption Amount cannot be finalised until the Redemption Date which (as discussed above) is not ideal.

It is preferable, therefore, for the existing lender and borrower to agree to close out the interest rate swap prior to the Redemption Date. A cautious approach would be to obtain existing lender consent to an early close-out in order to avoid a breach of the hedging letter applicable to the existing facilities. If early close-out is not possible then the parties may seek to adopt a similar approach to the payment of Break Costs (including the insertion of true-up mechanics) to ensure that there is no delay to the release of the Existing Security and completion of the acquisition.

It should be noted that where a borrower has taken out an interest rate cap (instead of a swap) and the premium on that cap has been fully paid, that cap will not need to be closed out as part of the redemption process as the borrower has no further payment obligation to the hedge counterparty in respect of the cap (and therefore the hedge counterparty will not benefit from the Existing Security) and accordingly should be treated as an ongoing asset of the borrower.

## CONCLUSION

Whilst the redemption of existing facilities is commonplace on leveraged buyouts, there are a number of pitfalls that can impact the smooth-running of the acquisition process if not properly considered and taken account of when drafting the relevant redemption documents. ■

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