New Year, New Potential for UK and European Private Placements

Week two of the New Year marked a significant step in the development of the European Private Placement Market: The Loan Market Association (LMA) launched template documents for use in European private placement transactions. The development of standardized documentation will improve the visibility and perception of the product and might provide the European private placement market with the potential to grow, in time, into a notable competitor to the US market.

It has also been announced that a new exemption from UK withholding tax on interest on private placements will be introduced later in the year. HMRC are consulting on the conditions for exemption. Withholding tax exemption will provide a boost for the market, but some of the proposed conditions seem unduly restrictive.

The Product

Private placements are generally long-term financing transactions by way of notes or loans between companies and a relatively small number of select investors. Investors tend to be mutual funds, insurance companies, pensions funds and banks. Private placements offer an alternative source of funding from public bonds and bank loans. They offer competitive pricing and long-term funding, with longer tenures than bank loans. Private placements are also particularly attractive to companies that require funding but do not wish to have a formal credit rating or be subject to the reporting requirements of the public debt markets. From the investor's perspective, private placements permit diversification and long-term relationships as, in contrast to public bond issues, investors negotiate directly with the company and do their own due diligence.

With the reduction of bank lending as a result of the credit crisis, there is an increasing demand for non-bank funding, including private placements, as companies seek to diversify their sources of liquidity. In Europe, the most developed private placement market is the Schuldschein market in Germany. France has developed a smaller Euro private placement market. The UK private placement market is still at its early stages. A number of UK companies that have a demand for private placements prefer to turn to the most established private placement market – the US.

US Private Placements

The US private placement market has a long history and is successful. US private placements typically take the form of US dollar fixed-rate notes that do not require registration with the SEC. They are available to US and non-US companies and can also be issued with tranches in other currencies. Life insurers are the largest investors in the US private placement market as, among other reasons, they often prefer long-term fixed rate products to match long-term liabilities. They also have the sophistication to assess the credit quality of the issuer and negotiate the covenants.

NAIC Ratings

One of the many reasons for the growth of the US private placements market is the private rating given by the National Association of Insurance Commissioners (NAIC) to US private placement notes. Insurance companies are legally required to obtain the NAIC rating for the notes they buy. The private rating has also become a big feature of the investment appraisal process of non-insurers. This NAIC rating indicates the relative likelihood that the note will be repaid in accordance with its terms. This feature of the US private placement market presents a significant advantage over the European market, where there is no equivalent. Non-bank investors in particular do not all have sufficient ability or experience to analyse unrated credits.

The rating system is also appealing for US and non-US borrowers that lack a public credit rating or do not wish to go through the time, effort, public scrutiny and expense of gaining and maintaining a public rating.

American College of Investment Counsel (ACIC) Templates

Another significant advantage of the US private placement market until now is that it benefits from well-accepted, standardised documentation. Template documents were prepared by the ACIC over twenty years ago. Although the detailed terms of each transaction will be negotiated by the borrower and investors, the templates create a framework for each deal. The acceptance of these templates as a starting point demonstrates and encourages the perception that the market is well established, efficient and cost-effective. In addition, parties are comforted by the perception that the terms are standard and enforceable. The main template is the note purchase agreement (NPA), which documents the agreement by the investors to subscribe for the notes and contains the borrower representations, warranties and covenants. For cross-border transactions, non-US borrowers use the Model X Form, for which there are two versions depending on the credit of the borrower. These are governed by NY law but are often amended so that they are governed by the laws of other jurisdictions. It is quite common for transactions with English issuers to be governed by English law. English law is also more and more frequently chosen by companies that are neither US nor UK issuers but which have a base in the UK or Europe.

The Model X Form contains some positive covenants requiring the issuer to perform certain actions. The negative covenants prohibiting issuers from taking certain actions are not included and are negotiated by the parties. The covenants in the US private placements are similar to those in the LMA bank facilities and will vary depending on the credit quality of the issuer. For strong issuers, investors often accept lighter covenants. For some strong credits, the negotiated position might be no financial covenants and just a "most favoured lender" clause, which needs to be drafted as it is not included in the Model X Form. This provision entitles the investors under the NPA to the same or better terms and covenants as those of the borrower's other financings. Any favourable changes to those other financings would be deemed to be made to the NPA. This is often included as a means to ensure that the private placement lenders will benefit from the same terms as the senior lenders.

The Model X Form contains language for a "make-whole" payment. Pursuant to the make-whole clauses, the company is required to pay a penalty if it voluntarily prepays or if it is required to prepay the debt before the stated maturity. A make-whole amount is calculated by reference to gilts or other government bonds, by determining the present value (using a discount factor) of the interest that would have been payable through to maturity had the debt not been repaid. The amount can be substantial and can be a deterrent to borrowers seeking funding in the private placement market.

The templates help to identify the US private placement product while retaining the flexibility to incorporate other features such as security for the transaction or a different company structure.

The LMA Recommended Forms of Pan-European Private Placement Documents

The lack of standardised documentation has hampered the growth of the UK private placement market. Since each transaction has to be drafted individually, this increases costs and, more significantly, the perception that the UK private placement product is not straightforward and little understood. Template private placement documents have not been developed in the German Schuldschein market, but some standardization exists in the documentation and is helping to make Schuldschein increasingly popular. There is no doubt that the launch by the LMA on 6 January 2015 of recommended forms of European private placement documents (the PP Documents) will help to increase familiarity with the product and boost awareness of the market.

ATTORNEY ADVERTISING

The PP Documents

The PP Documents include a recommended form of facility agreement, subscription agreement, term sheet and confidentiality agreement. These are all governed by English law but are adaptable to the laws of other jurisdictions. The term sheet allows the debt to take the form of a loan to be made available under a facility agreement or notes. The PP Documents are based on the LMA recommended form of single currency term facility agreement for investment grade transactions with covenants, events of defaults and other terms appropriate for investment grade companies. As in the US private placement market, it's common for the terms to be aligned with any senior bank debt. The sections are those of a syndicated facility agreement, although there are no agency and arranger provisions as the PP Documents assume that there is no agent or arranger. The subscription agreement is relevant for unlisted notes and closely follows the facility agreement format because of the desire to keep the terms commercially substantively similar.

The LMA has produced an accompanying User Guide to the PP Documents. The User Guide outlines the key features and assumptions of the PP Documents, the main ones being as follows:

- There is one company that will borrow or issue the debt, and the debt is guaranteed by a number of subsidiaries, with the guarantee being incorporated into the body of the document;
- The obligors are companies incorporated in England and Wales, and the lenders or subscribers and holders are based in England and Wales;
- There is no facility agent or arranger, but the facility agreement and subscription agreement include mechanics to incorporate the optional role of a paying agent or a calculation agent;
- The loans or notes are unsecured, and there are options for fixed or floating rate interest provisions (using, in the case of the floating rate option, LIBOR or EURIBOR as a benchmark);
- The facility or notes may only be drawn or issued once, and there is a bullet repayment;
- The subscription agreement assumes no minimum subscription amount;
- There are no recommended financial covenants. These are left to be negotiated on a case-by-case basis, and standard drafting can be found in the LMA's standalone guide to financial covenants.
- There is a placeholder for drafting relating to a make-whole amount or prepayment fee, but the PP Documents do not set out a formula for calculating the make-whole amount

Introduction of the Withholding Tax Exemption for UK Private Placements

The Government announced on 3 December, 2014 that it will introduce a new exemption from UK withholding tax for "qualifying private placements". This is expected to come into place later in the year following the finalization of regulations to be made under a power to be introduced in the Finance Bill.

Withholding tax has been an issue for UK private placements because privately placed securities will not be listed and so will not qualify for the quoted Eurobond exemption. Many investors will qualify for exemption from UK withholding tax under one of the UK's double tax treaties; however, this does not apply automatically but requires HMRC to specifically grant exemption following what can be a time-consuming administrative procedure involving tax authorities in two jurisdictions. In addition, the obligation to account for UK withholding tax rests with the borrower and in the context of a private placement with a number of investors taking the form of a debt security, it is very difficult for a borrower to be confident who the beneficial owners of the securities are at any time, meaning that borrowers have felt exposed to the risk of having to account to HMRC for withholding tax (at 20% on interest payments), which they were not aware they needed to withhold.

ATTORNEY ADVERTISING

On 10 December, 2014 HMRC published a technical note for consultation, setting out the draft primary legislation and HMRC's proposals for the detailed conditions to be included in secondary legislation in due course. The consultation is open until 27 February, 2015.

The envisaged conditions are:

- the issuer must be a trading company;
- the minimum issuance of a qualifying private placement by an individual company would be £10 million, and the maximum issuance by an individual company would be £300 million;
- the holder of the security must not be connected with the issuer;
- a qualifying investor should be a UK-regulated financial institution, or an equivalent entity authorised outside the UK carrying on substantially similar business (this needs further clarification from HMRC);
- a qualifying investor would be required to be resident in a "qualifying territory". This refers to a territory with which the UK has a double taxation treaty;
- The debt instrument must be unsubordinated to any existing unsecured debt of the issuer.

The technical note also specifies that the security must:

- be unsubordinated to any existing unsecured debt of the issuer;
- have a maturity of between three and thirty years;
- pay interest at a normal commercial rate;
- be issued in a minimum denomination of £100,000;
- Have no right to conversion into shares of the issuing company.

Where it applies the exemption can be expected to reduce the administrative burden and open up the market to investors in some jurisdictions where the double tax treaty with the UK does not eliminate UK withholding tax.

However, some of the conditions are disappointingly restrictive. It is to be hoped that HMRC will consider relaxing some of these conditions, particularly given that the rules will also be subject to an anti-avoidance motive test.

In particular, the need for investors to be regulated financial institutions needs to be clarified as noted above but may rule out some debt funds and other alternative finance providers. In addition, the need for investors to be resident in a qualifying territory would rule out some hedge funds, such as those based in the Cayman Islands. This approach can be contrasted with the quoted Eurobond exemption, which does not impose any requirements on the identity of investors. The inclusion of these conditions would also mean that the issue for investors in terms of identifying the beneficial owners of their notes is not eliminated.

The need for the issuer to be a trading company would also create structuring difficulties, as this will prevent group holding companies or finance companies from acting as issuers, even where the group as a whole is trading.

It is noteworthy that the new exemption will only apply to private placements structured as notes, even though the LMA gives the option for loans. The proposed withholding tax exemption is not reflected in the PP Documents, and these will need to be amended when the legislation implementing the tax exemption is introduced. Meanwhile, the LMA has welcomed the announcement of the new exemption.

ATTORNEY ADVERTISING

Outlook for European Private Placements

The development of standardised documentation has given the European private placement product an identity and more visibility. The withholding tax exemption is also likely to attract interest but runs the risk of excluding some investors who may otherwise be attracted to the market, unless the proposed conditions are relaxed. Even if the documents are only a starting point for each transaction, they provide something tangible as a reference point, which can then be compared to the templates for US private placements. As with its other documents, the LMA intend to review its PP Documents on a regular basis. This gives parties comfort that the PP Documents reflect current market practice and current law.

The US private placement market has attracted large companies from across the globe for many years. The market might face increased competition from the European private placement market now that some of the existing barriers to that market have been broken down. Nevertheless, the lack of an equivalent rating to the NAIC rating remains an important regulatory barrier.

If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney, or any of the attorneys listed below.

Maurice Allen
Brenda A. Coleman
Michael Kazakevich
W. Jane Rogers
Andrew Howard
Paola Bahari

ropesgray.com

This alert should not be construed as legal advice or a legal opinion on any specific facts or circumstances. This alert is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. The contents are intended for general informational purposes only, and you are urged to consult your attorney concerning any particular situation and any specific legal question you may have. © 2014 Ropes & Gray LLP

ATTORNEY ADVERTISING