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Structuring Challenges in Leveraged Buyouts in Israel

How foreign private equity sponsors and their lenders are finding solutions to local law structuring issues

Leveraged finance acquisitions have existed in the Israeli market for many years. However, for a variety of reasons, the financings of these transactions have faced structuring challenges mainly in relation to the credit support granted by the target group. Many transactions, in particular with corporate sponsors, were secured on the target's shares with recourse to the sponsor, and required a relatively large portion of equity — the result of local Israeli banks traditionally supporting levels of leverage lower than those foreign banks have typically supported. With an increasing amount of acquisitions in Israel by foreign private equity sponsors, structures are being challenged in an effort to maximize leverage (with limited recourse to the sponsor, as is the trend in Europe and the US), and consequently, to maximize the value of the security package, to get US and European lenders across the line.

This *Client Alert* provides an overview of the main local law structuring issues foreign private equity sponsors and their lenders usually face in the context of a leveraged buyout (LBO) of an Israeli target group, as well as recent trends in overcoming these issues.

Financial assistance

A major challenge for structuring LBOs in Israel is the restriction on the ability of an Israeli company to provide financial assistance: under Israeli corporate law, a company's grant of financial assistance for the purchase of the company's own shares is a distribution, which must meet the requirements for making a distribution under the Israeli Companies Law. These requirements are twofold: first, the company must have sufficient distributable profits (the "profits test"); and secondly, the company must be able to meet its debts as they fall due. In most cases, on closing of the acquisition, the target will not have significant distributable profits. In addition, Israeli law has no "whitewash" procedure to permit financial assistance. Therefore, absent sufficient distributable profits, an Israeli target company cannot provide an upstream or cross-stream guarantee, nor can it grant security in support of the purchaser's acquisition debt obligations. Consequently, maximizing the value of the security package is a major structuring challenge in Israeli LBOs.

We have seen a number of approaches to deal with this issue.

One available solution, albeit not necessarily the preferred solution for many lenders, is applying to the court for what is effectively a capital reduction. The Israeli Companies Law provides that the court can authorize a distribution even if the company has not met the profits test provided the company meets the debt service test. This route is tested and grants certainty, but due to the length of time for obtaining court approval, parties find seeking court approval impractical as a condition to closing. However, there are examples in the market of sponsors that have completed transactions without debt, or obtained bridge financing in their home countries without target support, and refinanced the equity or bridge finance post-closing in conjunction with court approval.

Another interesting trend seen in a number of recent transactions involves the acquisition vehicle and target merging on closing, thereby not only achieving the effect of the acquisition debt being pushed down to target, but also avoiding the need to meet the distribution tests. The argument being, the correct interpretation of the law is that if the statutory approval process for mergers (which is also designed to protect creditors) is followed, then to comply with a second set of creditor protection measures, namely capital maintenance rules, is unnecessary.

Certain sponsors have adopted the view that in target groups in which there are no financial creditors (other than the lenders on the transaction), there is little risk of challenge on grounds of breach of the financial assistance doctrine. This is debatable in principle, and should be considered on a case by case basis. Obviously, if the acquisition lenders refinance or otherwise finance existing debt in the target group, the borrowers in question can grant security, and any non-Israeli subsidiaries can also grant security under Israeli law.

In terms of receiving undertakings from group companies to distribute dividends so as to support debt service, notably, under Israeli law, while a company can adopt a dividend policy, a company cannot commit ahead of time to distribute dividends. Rather, the board must approve every distribution and determine whether the company meets the applicable tests at that time. Therefore, in many cases an obligation to make upstream loans (to the extent a dividend cannot be distributed) is introduced into the facility agreement. The company would have to consider granting such an upstream loan in the usual manner, taking into account corporate benefit and related issues.

Upstream and cross-stream guarantees

The term "dividend" in the Israeli Companies Law is defined broadly and includes granting an asset to a shareholder without valuable consideration. Therefore, many believe an upstream or cross-stream guarantee can be deemed a dividend. This raises not only the question of financial assistance (in an acquisition scenario) but whether the company can make a distribution. Moreover, if a guarantee were to be considered a dividend, then in theory the guarantee could be subject to withholding tax. Generally, a company can grant upstream or cross-stream guarantees if there is corporate benefit and the guarantee is done on market terms or otherwise makes business sense. A recent trend has seen the introduction of guarantee fees in an increasing number of transactions as a means for establishing that a guarantee is being given on market terms.

Enhancing security over key assets

Companies can take security over most assets including shares, real estate, bank accounts and IP. In order to enhance the security package, lenders may request that any key assets are identified, *e.g.*, IP assets, and separated from an Israeli company (either by an actual sale or synthetic transfer through a perpetual license) into a company in a lender-friendly jurisdiction in which fixed security can be created over that asset and easily enforced. A number of constraints may apply to this, including limitations on transferring IP outside of Israel if the Israeli Office of the Chief Scientist funded the IP, as well as adverse tax implications of such a sale.

Enforcement of security

Generally (and unlike English law where lenders may take advantage of the power of sale in the security document), self-help enforcement of security is not available under Israeli law and lenders must enforce security within a court-supervised process by appointing a receiver. Although Israeli financial institutions have the benefit of an exemption and may apply self-help in certain cases, traditionally, Israeli banks have avoided this route. Due to the time a court-supervised process can take, certain lenders create holding structures through lender-friendly jurisdictions to have the option of enforcing a self-help share pledge at the top of the corporate structure, instead of an Israeli share charge over the target. Even if local security is not the preferred route of enforcement, the share charges and floating charges created over the Israeli group companies offer some flexibility on enforcement, and also freeze the existing structure and protect the structure from third-party creditors and attaching parties.

Withholding tax

Under Israeli law, the interest an Israeli resident pays a non-resident is subject to withholding tax at a rate of 25%, unless a tax ruling or double taxation treaty providing for an exemption or reduced rate is available. Therefore, unless the lender is an Israeli financial institution (or a foreign lender booking the loan locally), the withholding tax will apply and would typically be grossed up. Israel has tax treaties with several countries, some providing more favorable rates than others. For example, the treaty with Luxembourg provides for withholding at 5%, Singapore 7%, the United Kingdom 15% and United States 10% for banks. In the context of a syndicated loan, under Israeli law, residency of each lender (rather than the facility agent) determines the WHT rate.

A look into the future - bridge to bond

Historically, Israeli acquisition financings have comprised of senior debt only. The size of most transactions required no additional layers of debt. That said, the expected pipeline of transactions contains larger financings that may require additional tranches of debt. This may well include a bridge to bond facility that can benefit from a relatively liquid local bond market and an exemption on withholding tax for traded bonds listed on the Tel Aviv Stock Exchange (TASE).

Historically, bonds issued by Israeli companies and marketed to both Israeli and non-Israeli investors were listed on the main list of the TASE. However, a main listing can be cumbersome and time-consuming, which in the case of most acquisition financings is not feasible. More recently, a small number of companies have listed high yield securities on the TASE institutional market, including the B Communications Ltd. offering in 2014. The listing on the institutional market benefits from the withholding tax exemption mentioned above. Although the process for listing securities on the TASE institutional market generally takes somewhat longer than listings on the unregulated markets in Luxembourg and Ireland (where many high yield bonds are listed), the process is significantly shorter than listing bonds on the TASE main list.

End note

Case law in Israel has not yet dealt with many of the issues raised in this note, and so the solutions the market has adopted are not the product of affirming case law. As the leverage finance market in Israel continues to grow, we expect existing structures to be further challenged and developed.

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