Overcoming challenges

Israel's LBO market is growing but local limitations are hampering Israeli companies' ability to provide financial assistance for their own acquisition

During the past two decades, the Israeli economy has been increasingly opening up to the global markets. Combined with the rise of the Israeli hi-tech sector, this has resulted in greater economic interest in the country.

As part of this trend, international sponsors and lenders have been taking an ever-increasing role in the development of a local LBO market. A few examples include the acquisition by Apex Partners of a controlling interest in Bezeq (previously Israel's national telecommunications operator), Tnuva (Israel's largest food manufacturer) and Psagot (Israel's largest investment house), as well as the recent acquisition by BC Partners of a controlling interest in Keter Plastic.

Such sponsors and lenders face some challenges, but there are available solutions.

Avoiding classification as direct financial assistance

The main legal challenge in structuring an LBO of an Israeli target is the limitations imposed on the ability of Israeli companies to provide financial assistance for their own acquisition.

> An alternative solution is using a reverse triangular merger whereby the LBO-related debt is undertaken by an SPV

According to the Israeli companies law, the purchase by an Israeli company of its own shares (including the direct or indirect provision of financing for such purpose) is considered a form of distribution, which can only be made out of distributable reserves and only on the basis it does not give rise to a reasonable concern that it would prevent the company from meeting its obligations when due.

Similarly, an Israeli subsidiary may only purchase (or provide financing for the purchase of) shares of its Israeli parent company to the extent that the parent company is itself entitled to do the same (ie, had such purchase been made by the parent company, it would not have been considered an unlawful distribution). It should be noted that where either the parent target company or the subsidiary are non-Israeli, then, based on our interpretation of the law, the restriction set out above may be irrelevant. However, for the sake of this review, the assumption is that both the target company and its relevant subsidiary are Israeli companies.

Obtaining court approval

Where the target company does not have sufficient distributable reserves to make a lawful distribution to its shareholders, the court may still allow such distribution, where this will not prevent the target company from meeting its obligations when due. While this route provides certainty once approved by the court, it is lengthy, public and hard to predict. Therefore, it is uncommon to see it being applied prior, or as a condition precedent, to the closing of an LBO. In a few cases, however, Israeli sponsors have used this method post-closing to transfer some of the debt to the target company. This is normally done by the target company applying to the court in order to permit it to undertake post-closing debt, which will be used to make distributions to its shareholders, who will in turn use these funds to repay some of their LBO-related debt. This method is quite straightforward. It has been contested, but in most recent cases, Israeli courts have upheld it.

Reverse triangular merger

An alternative solution is using a reverse triangular merger whereby the LBO-related debt is undertaken by a special purpose vehicle (SPV), which is then absorbed, together with the debt, into the target company. As the target company does not directly provide any financial assistance, and as the entire merger process is sanctioned by the court, it can be argued that the limitations on financial assistance are not applicable to such a transaction. It should be noted that whether this method would qualify as financial assistance or not, the entire transaction must be approved by the board of the target company, which should be comfortable that it is indeed in the best interest of the company itself. As with the first method described above, although this method offers certainty once approved by the court, it is lengthy, public and hard to predict. Although we believe that this structure, if properly used, should be legally upheld, it should be noted that the structure has not yet been tested before the Israeli courts. In addition, the potential tax implications arising from the use of this model should be considered on a case-to-case basis.

Avoiding classification as indirect financial assistance

A unique form of financial assistance is the provision of guarantees by the target company or its subsidiaries to secure the debt undertaken to finance the acquisition. While it is likely that the provision of such guarantee qualifies as distribution, it is still not certain what the value of such distribution is.

The common approach, which we agree with, is that the value of the distribution equals the cost of obtaining an alternative guarantee (an *ex ante* review). An alternative approach, however, is that the review should be done *ex post*, ie: what is the guaranteed amount? It is obvious the value of the distribution according to the second alternative is much higher. That being said, we believe careful structuring of the guarantees can exclude the applicability of the relevant limitations altogether. Also, we are of the opinion that if the provision of such guarantees is in the best interest of the target company or its subsidiary and they are provided on arm's length terms, there will be a strong argument that no distribution is made and that in any case the value of the guarantees would equal the actual cost of obtaining them. It should be noted, however, that this method as well has not been put to direct test before the Israeli courts.

Ensuring enforceability
Israeli law provides for two basic types of charges: a fixed charge over specific assets and a floating charge over all of the assets of a company (which may or may not include a negative pledge prohibiting the creation of additional charges). Most LBOs involve the grant of a fixed charge over the shares of the target company, a floating charge over the entire assets of the target company (if the target company is a borrower, a guarantor or an obligor) and, in some cases, additional fixed charges over certain assets of the target company (again, subject to it being a guarantor or obligor). Similar charges may be granted in relation to a subsidiary of the target company as well.

Israeli law includes various provisions relating to the registration, priority and enforcement of such charges, which exceed the limits of this review. However, there are a few main issues that are important to note.

No self-help
Under Israeli law, self-help enforcement of charges is not available to most creditors (other than certain Israeli financial institutions, who in practice only rarely do so for various reasons), regardless of contractual agreements to the contrary. Rather, security interest should be enforced by a court-appointed receiver or administrator. While Israeli courts tend to protect creditors' rights, lenders should take into consideration the potential complexity and delays resulting from such process. Subjecting the charge over the shares to a foreign law may help mitigate some of such risk.

No control agreements over bank accounts
Israeli law does not provide for control agreements over bank accounts. Moreover, most standard agreements of Israeli banks allow them to set off amounts between client accounts. and in some cases also grant them with liens and charges over such accounts. To mitigate this risk, it is advisable to open a new account with a bank, which has no dealings with the charger for the purpose undertaking the LBO debt.

Regulated sectors
Changes in ownership or control in companies in certain sectors (such as telecommunication, media, energy, banking, insurance etc.) may require specific approvals from the relevant governmental authorities, which, in most cases, have quite broad discretion. As it has already happened that such approvals were not granted, it is advisable that such matters are reviewed and addressed in advance, and that obtaining all the required governmental consents and authorisations is set out as a condition to closing.

Government-funded companies
Israeli companies that have received government funding, such as grants from the Office of the Chief Scientist, may also be required to obtain an approval prior to the grant of charges over relevant assets such as shares or IP. Accordingly, in cases where such funding was granted, sponsors and lenders are advised to understand in advance the scope of the applicable limitations and consider them, and to demand that obtaining the required approvals is a condition to closing.

Registered charges
Some material amendments to registered charges (such as an increase of the secured obligations) cannot be resolved by merely amending an existing registration and require that the amended charge be re-registered, thereby losing priority. While there are ways to mitigate the risks involved, the simplest solution is to draft the charge in a flexible and broad manner that would allow future amendments thereto to be considered as covered by the original registration.

Dividend as a source for repayment

In the vast majority of LBOs, dividends distributed from the target company are the main source of repayment of the loans. Accordingly, in some cases, the lenders demand that the sponsors ensure a sufficient steam of dividends to serve its debts. However, sponsors and lenders should be aware that while Israeli target companies may adopt such dividend policy, the decision to make a specific distribution should be made by the appropriate organs of the company (mostly the board of directors) after having considered that such distribution meets the distribution tests. In an Israeli company, the board's discretion cannot be fettered.

A need for a licence to lend?

New Israeli legislation, set to come into force in June 2017, aims to regulate the non-institutional financial services sector in Israel. Under this new legislation, companies that wish to provide certain financial services in Israel, including by providing credit to Israeli companies by way of occupation, must obtain an appropriate licence. In the case of LBOs, the law may be applicable in cases where the sponsor receiving the loans is an Israeli entity, or if the LBO involves an Israeli SPV to which the loans are granted. Moreover, due to the broad wording of the law, one could also argue, at least theoretically, that if the Israeli target is a guarantor or an obligor under the loan agreements, then the law would apply as well. It should be noted, however, that as the law is of territorial nature, it is yet to be clarified whether it will also apply to any loan between non-Israeli and Israeli entities, or whether such loans may be excluded from the applicability of the law in certain cases (for example, if the loans are originated outside Israel).

The law sets out a list of entities that are exempted from the licencing obligation, which includes mainly Israeli banks, insurance companies and other regulated financial institutions. The law however does not exempt banks or other financial institutions which are regulated outside of Israel. The law authorises the Ministry of Finance to exempt other entities from the licencing obligation, and we believe that once it is clarified that the applicability of the law is broader than was intended, it is quite probable that at least some non-Israeli financial institutions regulated outside of Israel will also be exempted.

To conclude, as this legislation was only recently enacted, it is obviously very hard to give any concrete analysis about its applicability and relevancy to the case of LBOs and foreign sponsors and lenders. We believe that it was not intended that the law would apply in such cases, especially if the loans are originated outside Israel. However, one should bear in mind that in the seemingly quite unlikely case that the law applies to such loans, it would require the lenders to comply with the requirements set out therein, including to incorporate an Israeli company that would need to apply for the appropriate lending licence.

The LBO market in Israel is rapidly developing. While there is increasing involvement of international sponsors and lenders and a tendency to use international standards and practices, domestic legislation and case law still somewhat lag behind. Certain questions are yet to be fully addressed by the courts and therefore reliance on actual market practice is highly important. As the market continues to grow and evolve, case law will gradually provide us with definitive answers.

By Itai Yonai and Nimrod Rosenblum, partners at Epstein Rosenblum Maoz (Tel Aviv)