The Acquisition and Leveraged Finance Review

Third Edition

Editor
Christopher Kandel

Law Business Research

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EDITOR'S PREFACE

Acquisition and leveraged finance is a fascinating area for lawyers, both inherently and because of its potential for complexity arising out of the requirements of the acquisition process, cross-border issues, regulation and the like. It can also cut across legal disciplines, at times requiring the specialised expertise of merger and acquisition lawyers, bank finance lawyers, securities lawyers, tax lawyers, property lawyers, pension lawyers, intellectual property lawyers and environmental lawyers, among others. An additional area of complexity and interest at the moment comes out of market forces that are driving convergence in the large cap leveraged financings between loan and high-yield bond products generally, as well as between different markets (particularly pressure on markets outside the United States to conform to terms available in the US market but sometimes also vice versa), and in some cases the market is still debating whether to adjust for differences in bankruptcy, guarantee or security regimes.

The Acquisition and Leveraged Finance Review is intended to serve as a starting point in considering structuring and other issues in acquisition and leveraged finance, both generally but also particularly in cases where more than just an understanding of the reader's own jurisdiction is necessary. The philosophy behind the sub-topics it covers has been to try to answer those questions that come up most commonly at the start of a finance transaction and, having read the contributions, I can say that I wish that I had had this book available to me at many times during my practice in the past, and that I will turn to it regularly in the future.

Many thanks go to the expert contributors who have given so much of their time and expertise to make this book a success: to Nick Barette and Gideon Roberton at Law Business Research for their efficiency and good humour, and for making this book a reality; and to the partners, associates and staff at Latham & Watkins, present and past, with whom it is a privilege to work. I should also single out Sindhoo Vinod, Aymen Mahmoud, Angela Pierre and Oliver Browne for particular thanks – their reviews of my own draft chapters were both merciless and useful.

Christopher Kandel
Latham & Watkins LLP
London
August 2016

Chapter 1

INTRODUCTION

Melissa Alwang and Christopher Kandel[1]

I OVERVIEW OF TYPICAL ACQUISITION AND LEVERAGED FINANCE DEBT PRODUCTS

A range of debt products has traditionally been used in acquisition and leveraged finance. As always, a combination of cost, the features of the debt product in question and availability has driven what is used for a given project.

We are operating in interesting times, because the credit crisis that started in mid-2007 has triggered an evolutionary process that has not yet ended – because the US leveraged finance market goes from strength to strength in relative terms, debt products that are more readily available in the US leveraged finance market have been turned to in parts of the world that would not have considered them in the past, such as US first lien and second lien financings for European or, to a lesser degree, Asian acquisitions and groups (and the market continues to grapple with whether to tinker with those products to eliminate differences arising from the fact that one cannot count on US Chapter 11 applying for a European or Asian target or group), and investors in certain debt products such as European mezzanine required changes to those products because of losses that exceeded expectations during the downturn, although that product is currently in something like hibernation because of a mismatch between lender and borrower pricing expectations.

In addition, the buoyant US loan market has been continuing to compete with the US high-yield market through its enthusiastic adoption of covenant lite loans; and because the US loan market has shown itself to be available for international financings even where there are minimal US revenues in the group or acquisition being financed, this in turn is pressuring the European market to adopt less restrictive terms for loans and since the beginning of 2014 there has now been a reasonable number of European placement covenant-lite loans, in addition to the relatively numerous and earlier US placement covenant-lite loans for European acquisitions or groups.

1 Melissa Alwang and Christopher Kandel are partners at Latham & Watkins LLP.

The principal debt products normally turned to for acquisition and leveraged finance are:

a bonds and notes, usually referred to as high yield (or, less flatteringly, junk) bonds;

b senior secured loans;

c super-senior revolving credit facilities (super senior RCFs) or asset-backed borrowing base revolvers (ABL revolvers), usually made available alongside bonds or unitranche loans (in the case of super senior RCFs) or senior secured term loans (in the case of ABL revolvers);

d second lien loans or bonds;

e mezzanine loans;

f unitranche loans; and

g payment in kind (PIK) loans or bonds.

The following discussion gives an overview of the principal features of these products.

i Bonds

Bonds have been a staple of leveraged and acquisition finance since the early 1980s. In contrast to the type of bonds issued by investment grade issuers, which have relatively few covenants (undertakings) beyond a limited negative pledge, investors in below investment grade debt typically require a covenant package that allows the issuer to conduct business in the ordinary course without restriction, but requires it to pass financial ratio testing before undertaking certain actions that are perceived to potentially alter credit quality and are beyond certain pre-agreed limits or 'baskets'. Examples of these kinds of actions include making minority investments, paying dividends, incurring debt and granting security. These types of covenant packages are known as 'incurrence covenants' because the ratio tests only apply if the action in question is actually taken – the key point being that the issuer does not involuntarily go into default until it runs out of cash, even if its business is deteriorating and it could no longer pass those ratio tests.

Initially, high-yield bonds were contractually subordinated by their terms (i.e., 'senior subordinated notes') but never featured standstill provisions, largely because they were developed first in the United States as a publicly registered security,[2] and a standstill period upon an event of default violates the US Trust Indenture Act, which, *inter alia*, specifies certain required characteristics for public debt securities.

Over time, more and more US-issued high-yield bonds were issued without being contractually subordinated, even where they were intended to be junior to senior loans, because the lenders of the senior loans were and are comfortable relying on the relatively comprehensive guarantee and security packages that are available in the US. In addition, contractual standstill periods on default are largely superfluous where Chapter 11 applies with its automatic stay – effectively a standstill for everyone other than the limited categories of creditors who are exempted from that stay.

2 Technically, these were usually initially placed in a private placement without US Securities and Exchange Commission (SEC) registration, but were almost always subsequently exchanged for an SEC-registered security.

The high-yield market outside the US followed the US lead, although with a several-decade lag before becoming a volume market albeit still dwarfed by the size of the US market. However, the European market focused on the fact that, depending on the jurisdiction outside the US, the consequence of accelerating debt usually is to cause an insolvency of the issuer with the initiation of a bankruptcy regime that, again outside the US, can be value-destroying compared with a consensual workout or Chapter 11. It was therefore for many years the norm in Europe to structurally subordinate the high-yield issuer (that is to say, to make the high-yield issuer a parent of the borrower of the more senior debt in the debt capital structure) so as to reduce senior debt holders' concern about the lack of a standstill feature in the bonds. The structural subordination was also helpful – from the viewpoint of the more senior debt – in enabling the operating businesses to be sold in a security enforcement, leaving behind the claims of the high yield in a way that often could not otherwise be achieved absent seeking Chapter 11 protection.

These structures, particularly in Europe, led to certain workouts during the 2001–2005 period in which European bondholder recoveries were unexpectedly poor compared with the historical US experience. As a result of pressure from investors who perceived the poor recoveries to have been due to the structural subordination rather than the quasi-venture-capital nature of some of the European issuers that had been funded in this way prior to that period, high-yield bonds continued to be structurally subordinated but, for the first time with the Brakes Brothers issue in 2004, received upstream senior subordinated guarantees that would only be released in a senior security enforcement scenario if certain 'fair value' requirements were met. These have been standard in high-yield bonds in Europe ever since.

In a development that, at least outside the US, began in 2005 with the Cablecom high-yield issue, high-yield bonds started to be issued to occupy the position of what had formerly been the senior secured term loans in a debt capital structure, and enjoyed security alongside the first super senior RCF with covenants that largely tracked the bonds (but in addition had one maintenance financial covenant – see below for an explanation of what a maintenance financial covenant is). In 2009, Virgin Media issued the first senior secured bond that was *pari passu* with senior secured term loan debt – the senior term loan lenders initially agreeing to that structure largely because the proceeds were used to part prepay them and therefore reduce their overall lending exposure (this was a period when banks held many assets on their books below par and were seeking liquidity).

This new market further developed in 2010 with CVC's acquisition of the Swiss telecoms company Sunrise. In that case the acquisition was financed not only with senior secured term loans but also with the first issue of senior secured bonds that were both *pari passu* with those term loans and formed part of the initial acquisition finance structure.

Senior secured bonds, whether the main term debt in a structure and sitting alongside a super senior RCF or truly *pari passu* with other senior secured term loan debt, have matured and become a normal feature in cross-border acquisition finance in just a few years.

Where bonds are intended to finance an acquisition, there usually is a need to show the vendor (or, in a take-private transaction in many jurisdictions, a regulatory body although, interestingly, this is not required in the US) that the funding will be forthcoming. This is normally achieved through underwriting banks committing to provide a bridge loan, with the acceptable degree of conditionality depending on vendor requirements or, in take private transactions with these kinds of requirements, regulatory requirements for 'certain funds'. Bridge lenders prefer to be refinanced as soon as possible and structure bridge loan pricing and certain other features to encourage this, so the acquirer may issue bonds in escrow, pending closing of the acquisition, and it is not uncommon for the target to agree to cooperate in helping the acquirer issue the bonds as this requires substantial diligence and disclosure regarding the target.

Bonds normally pay a fixed rate of interest (although floating rate notes, bearing a floating rate of interest, are also seen, depending on the market) and also normally have a limited initial period where they cannot be prepaid or involuntarily redeemed, or can be prepaid at an expensive make-whole rate.

ii Senior secured loans

Loans come in all kinds of sizes, shapes, currencies and governing laws. While they can be bilateral (i.e., one lender extending credit to one borrower), in acquisition and leveraged financings these normally take the form of a credit or loan facility under which a group of lenders (known as a syndicate) makes available loans or other extensions of credit, or both, to one or more borrowers, with one or more initial members of the syndicate appointed as the administrative or facility agent, security agent or the documentation agent for administrative purposes.

Larger credit or loan facilities are normally arranged by one or more arranging banks and, given the need for certainty of funding of an acquisition, these banks normally also underwrite the facility, with a subsequent syndication to bring in additional lenders in due course. Refinancings may be done on an underwritten basis, but also are often done on a 'best efforts' basis where one or more arranging bank syndicates the facility but does not agree to provide the funding should the syndication fail to attract sufficient investor interest.

The Loan Market Association in London has published syndicated loan agreement forms that are widely adopted in Europe as a starting point for English law (and certain other law) loans, with trade bodies in some other jurisdictions following their lead and making similar efforts. The much larger US leveraged loan market has never succeeded in adopting a common form for loans or credit agreements, but the Loan Syndications and Trading Association has published forms for a variety of boilerplate provisions and ancillary documents, and market forces and the need to reflect market practice do ensure that there is a large degree of commonality in US law syndicated loan financings.

Loan agreements historically imposed financial ratio tests under which the borrowing group is required to maintain certain minimum levels either at all times or at periodic testing dates (usually quarterly). These are known as 'maintenance financial covenants', and the traditional suite of these consisted of an interest cover ratio test, fixed charge cover ratio test, leverage ratio test and a limitation on the permitted amount of capital expenditures. Starting in the mid-2000s, many larger loans omitted all but a leverage ratio test and were referred to as 'covenant loose' and a number of covenant-lite loans, omitting these tests entirely, were made on both sides of the Atlantic before the credit crisis disrupted the loan markets for a period. In recent times there has been a resurgence of covenant-lite loans-first, enthusiastically, in the US, and from 2014 also regularly in Europe albeit not available for every borrower.

A typical traditional European acquisition financing facility may provide for up to three term loan facilities, each with different features to appeal to different investor types but almost always providing for a floating rate of interest:

a an amortising term loan facility, where the investors are often banks;

b one or two term loan facilities, usually with no or minimal amortisation and maturing after the amortising term loan facility (and bearing a higher interest rate), designed to appeal to institutional investors and usually referred to in the market as a term loan B; and

c an RCF to provide liquidity for working capital and sometimes other needs.

In recent times, it has been common to omit the amortising term loan facility in many European facilities, albeit not as commonly as in the United States.

The RCF can often be drawn in the form of fronted letters of credit (LCs) or bank guarantees, where one bank (the issuing bank) issues the LC or bank guarantee but is backstopped by the syndicate participating in the RCF. Basel III costs to the fronting bank in relation to the indemnities it receives from the other lenders have resulted in most banks being unwilling to act as fronting bank at the moment, so the future of these kinds of arrangements is currently uncertain, and the market occasionally experiments with syndicated LCs (one piece of paper signed by an agent on behalf of the lenders, but representing several credit exposures of the individual lenders, so potentially presenting a collection challenge for the beneficiary in the event that any of those lenders default) and other bilateral LC issuances out of an RCF as an alternative.

European RCFs also often allow a lender to carve out some or all of its commitment so the lender can make it available bilaterally for whatever local use the borrower might need, while still benefiting from the guarantee and security package of the main facility. These are referred to as 'ancillary facilities', and are the way many European groups obtain local overdrafts, custom clearance facilities, trade LC facilities and the like. At the moment, this is the most common way to replace the LC facilities while no bank in the syndicate is willing to act as a fronting issuing bank for an LC issued directly under the RCF.

A typical US acquisition financing facility would provide for a term loan facility and a cash flow revolving facility secured on a *pari passu* basis with the term loans. Revolving facilities in the US market may be provided on such a cash flow basis as part of the same credit agreement documentation for the term loans financing the acquisition. Additionally, as discussed in detail below, revolving facilities may be provided as part of an 'asset-backed' facility (ABL facility) that is documented separately from the acquisition term loans. Unlike the cash flow revolving facilities, the ABL facilities are senior to the term loans with respect to certain highly liquid types of collateral (typically inventory and receivables). The lenders to the revolving facilities are typically banks (most typically the arranging banks), whereas the investors for the term loan facilities are typically institutional investors. As noted above, amortising term loans are rare in the US acquisition finance market although there is typically nominal (1 per cent per annum) amortisation in the US term loan B market. LCs are also available under these cash flow revolving facilities or ABL facilities.

US market revolving facilities will also often allow one lender to make bilateral 'swing line' loans under the credit agreement on shorter notice, to be refinanced later with drawing under the revolving facility. These are seen in Europe, too, but curiously only for investment grade borrowers.

Covenant-lite term loans will frequently be made alongside a RCF that is *pari passu* and documented under the same facility agreement, so the RCF benefits from all the same covenants as the term loans. However, the RCF will also normally benefit from one maintenance financial covenant that the term lenders don't benefit from unless the RCF lenders accelerate on the basis of its breach, and it is also entirely within the RCF lenders' gift whether to amend, waive, etc. that maintenance financial covenant. This kind of maintenance financial covenant is typically tested quarterly but only if RCF usage is in excess of some level ranging from 15 to 35 per cent at quarter end or, albeit less frequently these days, RCF usage over the quarter exceeds an average amount threshold, and this kind of covenant is known in the market as a 'springing covenant'.

iii ABLs and super senior RCFs

As noted above, in the US market an ABL facility is typically used alongside senior secured term loans or senior secured bonds where the borrower has an asset base that makes an ABL facility a cheaper and more flexible form of financing for the borrower's working capital needs. The ABL facilities take a first lien (first priority security interest) on the most liquid forms of collateral, typically receivables and inventory, and then advance funds based on a 'borrowing base' formula that is designed such that the amount of credit extended does not exceed the discounted value that the lenders expect to receive upon the quick sale of that liquid collateral. ABL facilities have been around in the US market for a very long time, but have only more recently been used in large-cap financial sponsor-led leveraged transactions alongside term loans or senior secured bonds.

There are many factors that make ABL facilities attractive to borrowers, including an all-in lower cost and an absence of leverage covenants (typically only a fixed charge coverage maintenance covenant, although springing; i.e., not tested if outstandings under the ABL revolver are below a negotiated level). From the lender perspective, a well-managed ABL facility may represent a better compensation-to-risk ratio than a cash flow revolver (which is *pari passu* with the term loans) for the same credit.

The documentation typically allows the ABL lenders to freely liquidate ABL first lien collateral without interference from any other secured lender. This gives the ABL lender a high degree of control not available to *pari passu* cash flow revolvers that form part of the main term loan credit agreement.

The super senior RCF developed out of the increasing popularity of the senior secured notes discussed above, albeit mostly outside the US; while they appear from time to time in the US, they are relatively rare there. Starting in 2005, but with a noticeable acceleration in frequency since 2009, senior secured notes in Europe have often been used to provide the term loan debt in debt capital structures, leaving the borrower with a continuing need for the liquidity and other features of an RCF (unless the notes provide overfunding). This is often dealt with in Europe by the underwriters arranging a super senior RCF.

A fine balance exists between the interests of the holders of the senior secured notes and the super senior RCF lenders (who receive only 30 to 40 per cent of the margin while commitments are undrawn, so arguably are undercompensated for the inherent credit risk if one assumes that the RCF will be fully drawn before defaults occur and if one disregards the other fees being paid). In these structures, the notes are typically not subordinated in any way to the super senior RCF, but all security enforcement proceeds and distressed disposals of collateral (and sometimes certain other amounts) are applied under a waterfall where the super senior RCF lenders are paid first.

There is also a finely negotiated arrangement as to who controls security enforcement in the event there is no agreement as to the best course of action. Broadly speaking, there usually is a six-month period where the note holders can take control, but if no enforcement action is taken within a specified initial period (often three months), or the super senior RCF has not been repaid in cash in full within six months, control shifts back to the RCF lenders.

Again, broadly speaking, a typical European super senior RCF:

a has the same negative covenants (usually 'interpreted' under New York law, even though the facility is governed by English or another law) as the associated senior secured notes, modified to reflect structural differences and to back out the effect of equity cures on various baskets that otherwise increase in size for equity injections;

b has loan agreement style representations and affirmative housekeeping covenants;

c may have a maintenance financial covenant (very infrequently, two), usually set at around 30 to 40 (and sometimes even 50) per cent above the model; this maintenance financial covenant may also have a springing feature along the lines discussed above or, in some super senior RCFs as negotiated, may only act as a draw stop rather than a breach if exceeded;

d usually has some kind of 'note purchase covenant' requiring the facility to be reduced in size if the other debt in the structure is reduced to an extent where the super senior RCF has become a disproportionately large part of the group's debt capital structure (this is heavily negotiated);

e may have certain additional undertakings dealing with issues that loan lenders are concerned with but that the senior secured bond covenants do not normally address, such as acquisitions of targets doing business in sanctioned countries; and

f may have term loan agreement style events of default, or the same events of default as the associated senior secured notes with a few technical changes, such as the addition of a misrepresentation event of default (high-yield note indentures do not have representations and warranties, and consequently do not have a misrepresentation event of default).

iv Second-lien loans or notes

The US has a long-established second lien market, with the second lien taking the form of either notes (i.e., high-yield bonds) or loans. The main distinguishing feature of second lien in the United States is that as a payment obligation (both for the primary obligor and any guarantees) it is an ordinary senior claim with no subordination features of any kind, and therefore is *pari passu* in every way with the first-lien debt. It is also given the benefit of second ranking security over the same assets over which the first-lien debt has security, typically (in the US) under a separate set of security documents with a different security agent. The practice is different in many other jurisdictions where there may be a common security agent or trustee holding one set of security for the two different classes of secured creditor, but as noted this security (however documented) ranks second to the first-lien security.

When the second lien takes the form of notes, the second-lien debt's ability to enforce security is often 'silent' (i.e., it cannot enforce the security separately from the first lien, so it is just piggyback security). Otherwise, the second lien often has a security enforcement standstill period, which varies in length as negotiated but is often 120 days, after which the second lien can initiate a security enforcement.

This dichotomy between the senior claim and the second ranking security position is one of the important features of US-style second lien and why it is turned to in certain financings – its incurrence does not breach the terms of the typical 'limitation on layering' covenant that one finds in senior subordinated and certain other high-yield bonds, due to the fact that the second lien is not contractually subordinated to other senior debt.

It should be noted that even where the second lien features a standstill period (or in the case of the silent second lien version, a quasi-permanent security enforcement standstill), the second-lien debt can still immediately accelerate and take other unsecured enforcement action even during the standstill period because as noted the standstill period only applies to the security enforcement. As an acceleration or other enforcement action will usually tip the borrower into a Chapter 11 process in the United States, and in that process the second-lien holders will get the benefit of their security, even the indefinite standstill feature in the US is not as draconian as it might at first seem. In other jurisdictions, this avenue for second lien holders being comfortable with a silent second lien may not exist.

There is much more variation as to what 'second lien' means in the European market, driven in part because of different investor expectations and different senior lender requirements, but also because European insolvency laws work differently from the US where second lien first evolved and because guarantee and security packages in many European jurisdictions are not at all comprehensive, unlike the relatively comprehensive US guarantee and security packages where any limitations (such as under US fraudulent conveyance or transfer law) generally affect the first-lien and second-lien debt equally and are unlikely to result in a *pari passu* recovery for the second-lien debt.

Prior to 2008, very few European second liens followed the US model exactly, and most of those that did follow that model had German issuers. More typically, European second lien in that period was an extra tranche of debt under the main senior credit agreement (often referred to as Tranche D), which for most things voted as one class together with the rest of the debt under the senior credit agreement and therefore could normally be outvoted (i.e., this form of second lien did not control its own debt instrument, in contrast with the US model).

Tranche D normally only had a separate vote in limited circumstances, such as a Tranche D payment default or an insolvency. It was also contractually subordinated on a quasi-European mezzanine basis (see below), with both subordination of the debt claim and the security, plus a standstill period layered on top (normally 60 days following notice to the other lenders).

Between 2007 and November 2013, there were no European second-lien issuances at all as far as we are aware. Since then, there have been a few Tranche D second-lien issuances; there has also been a wave of a new European form of second lien, where the second lien is made available under a separate facility agreement that, from a form and legal status and security point of view, largely follows the model of European mezzanine debt (discussed below) or, occasionally, European mezzanine intercreditor terms but otherwise following the model of US mezzanine debt (discussed below). More and more of these, while having European mezzanine-style payment blocks and standstills, do however allow unsecured recoveries to be applied *pari passu*.

There is also a further line of European second lien that follows the US model with one important difference – while the debt claim against the issuer or borrower is senior and not subordinated or subject to standstills and is consistent with the US model in those respects, the claims against guarantors are run through the security enforcement waterfall but not otherwise subordinated or subject to standstills. The net effect of this is to quasi-subordinate the second lien claims against the guarantors, because the first lien gets the proceeds first.

v Mezzanine debt

Mezzanine can mean different things to different people. In Europe, for leveraged and acquisition financings,[3] it normally means a contractually subordinated bullet maturity floating rate term loan that, while in a separate loan agreement and maturing after the senior debt in the same structure, is largely a photocopy of the senior loan facility agreement in substance, other than that the financial covenants are typically rolled back approximately 10 per cent. It is also normally secured on a second-ranking basis to the senior debt, with standstill periods and payment blocks applying as negotiated, and there has been significant movement in the intercreditor terms negotiated between senior and mezzanine lenders in European financings over the past few years.

In the US market, mezzanine finance is typically provided under a private high-yield instrument, with bond-like terms, although this kind of mezzanine is also increasingly seen in Europe, albeit usually as a high-yield bond replacement. It is also most often unsecured (in the United States).

There are only isolated examples of mezzanine debt in the same capital structure as high-yield bonds, in part because European mezzanine debt normally contains maintenance financial covenants unlike bonds, so there would be the oddity – particularly if the bonds are senior secured – of a junior part of the debt structure having tighter covenants than the more senior debt.

Mezzanine lenders can from time to time require warrants as an 'equity kicker', but this is rare in larger deals.

The mezzanine product, in contrast to second lien, has become very rare in the European market over the past two years owing largely to the target returns of the mezzanine lenders being considered too high by borrowers in the current low interest rate environment.

vi Unitranche

Unitranche (or sometimes 'stretch senior') loans are increasingly being seen, and noticeably the amount of debt that can be obtained under a loan taking this form is increasing in size so the product is migrating into the mid-cap market. In form, these are usually senior loan facility agreements that in all respects except the pricing (interest and margin, fees, sometimes warrants and board observer rights and the like) are the same as an ordinary senior loan, except that the aggregate amount being lent is normally greater than senior lenders would typically be comfortable with. In other words, unitranche covers some of the same debt funding territory as mezzanine or other subordinated debt would have covered, in addition to the senior debt, albeit all in one blended term loan tranche or facility agreement.

This product has been growing in popularity for mid-market and smaller financings over the past few years; it has the attraction of simplicity, since there is no need to document a complex intercreditor relationship as between the senior and mezzanine or other subordinated debt encompassed by the one unitranche instrument.

Investors in unitranche instruments may, however, wish to allocate losses and return between themselves in a way reflecting relative senior and subordinated positions, so there can be complexities in the behind-the-scenes funding of unitranche loans.

3 A discussion of the very different mezzanine structures in real estate finance lies outside the scope of this survey.

Unitranche loans are often put in place alongside either a stand-alone ABL or super senior RCF.

vii PIK loans or bonds

While any debt instrument can feature PIK interest (i.e., the interest is rolled into principal, or otherwise compounded), what the market normally refers to as PIK is usually a holding company issue of notes or loans, issued above the restricted group under the covenants of the debt applying to the more structurally senior debt of the group, where the terms of the PIK largely track the terms of the structurally more senior debt but, in addition, further limit payment of dividends (by the PIK issuer or borrower). There is also a great deal of variation in what other debt or activities the PIK issuer or borrower can have and on certain other terms.

Originally, PIK debt permitted but did not require payment of cash interest (referred to as 'pay if you want'). In the past few years, there have increasingly been PIK financings that require payment of cash interest to the extent there is sufficient available cash that is able to be upstreamed to the PIK issuer or borrower from its subsidiaries, under the terms of the covenants imposed by the more senior debt in the relevant debt capital structure (this is referred to as 'pay if you can' but also sometimes 'PIK toggle', although that term's original meaning encompassed a more limited concept of the ability to elect, usually only a few times, to switch from cash pay to PIK).

PIK debt is sometimes used as part of an overall acquisition structure, but more often is put in place to finance a dividend (i.e., to release some equity value to shareholders).

II CONCLUSION

As noted above, debt products are continuing to evolve as a result of market forces, regulatory changes and other factors. It is likely that the discussion in this chapter will need to be supplemented in only a few years' time.

Chapter 2

AUSTRALIA

John Schembri and David Kirkland [1]

I OVERVIEW

Australia has a long history of merger and acquisition activity, and consequently, the debt financing of these acquisitions is a well-trodden path for lenders and borrowers alike. Traditionally, the senior debt financing of acquisitions in Australia has been the domain of the banks, international and domestic, with the local 'Big Four' banks often taking lead roles in relation to the arranging and underwriting of these facilities.

Typically, an Australian acquisition finance package will feature an amortising term loan A, together with a bullet term loan B, to fund the acquisition of the target group. These facilities will generally be accompanied by a *pari passu* revolving facility that is designed to meet the target's working capital or contingent instrument needs, or both, post-acquisition. Capital expenditure or acquisition facilities are often also included as required (generally on a committed basis). Subordinated debt provided by specialised institutions (usually in the form of mezzanine loans or local capital markets products) also often features where the acquisition is of a sufficient size. Recently, there has been a trend for mezzanine funding to be provided at a level above the bank group at a holdco level. This enables sponsors and senior lenders to avoid much of the complexity that comes from having this subordinated debt provided at (or just above) the level of the senior debt.

As a general rule, loan documentation in the Australian market is relatively standardised, thus enabling loans to be drafted, priced and syndicated to a wide pool of financiers.

1 John Schembri is a partner and David Kirkland is a senior associate at Gilbert + Tobin. The authors would like to thank Deborah Johns, Alex Kauye, Andrew Sharp, Mack Wan and Jessica Kim for their assistance with the preparation of this chapter.

From a market perspective, there was a relative decline in activity experienced by the local syndicated loan market in 2015 with total volume of US$79.9 billion from 186 transactions (which is 40.4 per cent lower than in 2014).[2]

This was attributable partly to a weaker Australian dollar affecting foreign exchange translation of non-US$ denominated debt but also to changing investor sentiment given the low growth environment among emerging economies. There are also continuing challenges in the resources sector (both domestically and globally). The slowdown continued into the first half of 2016 with syndicated lending volumes of US$31.7 billion from 63 deals.[3] Major transactions in the acquisition and leveraged finance space in the second half of 2015 included Macquarie Bank's acquisition of ANZ's vehicle finance portfolio Esanda, which was funded via a US$4.3 billion bridging loan. Government asset privatisations also played a key role in the market in 2015 and early 2016. Most notable was the financing provided to a Hastings-led consortium for the A$10.3 billion lease of TransGrid as the first of three standalone transactions contemplated in connection with the privatisation of NSW's electricity assets.

Growth in the infrastructure sector is expected to continue with the long-term lease of AusGrid and Endeavour Energy to follow, as well as the privatisation of various government-owned ports (including Port of Melbourne and Port of Freemantle) and other assets (such as the NSW government's planned privatisation of its real property titling and registry agency) still in progress. The completed and planned privatisations will unlock significant capacity within each respective state to invest into new transport and social infrastructure projects, which in turn, promises to generate additional deal flow.

M&A activity in the private equity space has been strong, with 2015 characterised by record-breaking mega-deals contributing to a total value of A$105.1 billion from 27 transactions,[4] including the acquisition by the Qube and Brookfield consortium of Asciano Ltd for A$9.05 billion.

Notwithstanding the effect of these transactions, the bulk of M&A activity, and accordingly the debt financing, has been firmly rooted in the 'mid-market' sector (which comprises companies with an enterprise value of up to A$250 million). Some notable transactions for sponsors in this space included Anchorage Capital's acquisition of Affinity Education, Archer Capital's acquisition of Dun & Bradstreet, and Crescent Capital's acquisition of DB Dental.

A key trend is the growing appetite of foreign corporations for investment into Australian growth industries. This has increasingly placed sponsors in a competitive sale process with the potential to be 'priced out', although sponsors continue to hold their own against foreign corporations with deep pockets. Consequently, given the strength of the balance sheets of these corporations, the impact on more traditional debt-financed transactions remains to be seen.

The leveraged finance market also looks to be shaped by happenings in the restructuring space. Both the receivership of Dick Smith (a recently listed retailer from private equity ownership) and the administration of Arrium (a listed group in the metals and mining space) have the potential to inform bankers' views well into the future. In the case of Dick Smith,

2 Source: Thomson Reuters Global Syndicated Loans Review, full year 2015.

3 Source: Thomson Reuters Global Syndicated Loans Review, first half 2016.

4 Source: Pitcher Partners, 'Dealmakers: Mid-Market M&A in Australia 2016.

lenders are now scrutinising credits in the retail sector with an increased vigour – paying significantly more attention to their security package, as well as the quality of their borrower's reporting obligations, to address perceived deficiencies. Similarly, with Arrium bankers are increasingly more cautious when lending to the resources sector, and are keen to avoid the circumstances that led to them providing A$2.8 billion in unsecured loans to a group in a troubled sector. From a private equity perspective, Arrium also serves as a cautionary tale in light of the fact that the placing of the group in administration was pre-empted by GSO's attempt to recapitalise the group through a control transaction which was ultimately rejected by the group's lenders.

Despite the relatively slow start to 2016, it is expected that the current low interest rate environment will continue to draw M&A-related financing activity to the local market led strongly by non-resource related sectors including healthcare, education and financial services.

The ability to tap the US Term Loan B (TLB) and high-yield markets has been affected by heightened global volatility and uncertainty, particularly within the energy and mining sector. Sustained weakness in commodity prices affecting profitability and coverage ratios have elevated market pricing. This has translated into a material slowdown in the number of private equity and corporate issuers accessing the TLB market to take advantage of the longer tenor, less restrictive covenant structures and more flexible deal terms. While DTZ (among others) successfully executed substantial incremental debt offerings under its TLB in 2015, the present high-margin environment in the US is expected to continue into 2017. There are some concerns that this may begin to affect issuers in other sectors who are looking to refinance their offshore debt in unfavourable market conditions.

Since the final quarter of 2015, and despite still being at relatively low levels, loan market pricing has been skewing upward as a result of cost of funds pressures, regulatory change, and increased global volatility and uncertainty. In this environment, the alternative debt market will have a greater role in meeting the funding requirements of borrowers.

There are positive signs that M&A activity in the private equity sector will continue to drive investment and leveraged finance issuances in 2016. Additionally, the upcoming privatisation of several large government-owned infrastructure assets is expected to fuel market activity.

II REGULATORY AND TAX MATTERS

i Regulation of foreign investments in Australia

The Australian Foreign Acquisitions and Takeovers Act 1975 (Cth) (FATA) and its associated regulations (administered by the Foreign Investment Review Board (FIRB)) regulate the making of investments by foreign persons in Australian companies and assets (and in some cases offshore companies with the requisite Australian connection). Recently, the Australian government adopted significant amendments to FATA, which affect the circumstances (and manner) in which notification to, or approval by, FIRB is required.

Under the new regime, there are two kinds of transactions:

a Notifiable actions: failure to notify these transactions is an offence under the law, and the treasurer has the power to block or unwind these transactions if he or she considers them to be contrary to the national interest.

b Significant actions that are not notifiable actions: failure to notify these transactions is not an offence under the law, but the treasurer still has the power to block or unwind these transactions if he or she considers them to be contrary to the national interest.

FIRB approval is generally required where foreign investors are looking to acquire a 'substantial interest' being 20 per cent or more of an Australian entity with total assets of (or a foreign entity that holds Australian assets of) more than A$252 million (indexed annually). Separate value thresholds apply for these kinds of acquisitions by non-government investors based in the US, New Zealand, South Korea, Japan, Chile and China[5] (currently A$1.094 billion for acquisitions in non-sensitive businesses[6]).

FIRB approval is also required where a 'foreign government investor' (defined as an entity that is at least 20 per cent owned by a foreign government, its agencies or instrumentalities or by another foreign government investor, or at least 40 per cent-owned by multiple foreign governments, their agencies or instrumentalities or by other foreign government investors) is seeking to obtain an interest of (generally) 10 per cent or more in an Australian entity or business (5 per cent if the acquirer has entered into a legal arrangement relating to its business and the Australian entity or business and any percentage if the acquirer is in a position to influence or participate in the central management and control of, or the policy of, the Australian entity or business (such as appointing a director)). This typically affects Chinese investors, which are ultimately state-owned, and North American public pension funds. It is also important to note that (contrary to the statutory regime applying to most investors) an offshore transaction in which the acquirer is a foreign government investor can be caught as a notifiable action if the foreign target has any Australian business (other than where the Australian assets are less than 1 per cent of the target's global assets and are worth less than A$10 million and are not assets of a sensitive business).

Other notifiable actions include most acquisitions of land,[7] acquisitions of (generally) 10 per cent or more of an Australian agribusiness with an investment value above A$55 million (indexed annually)[8] and acquisitions of at least 5 per cent of an Australian media business, regardless of value. Other kinds of transaction may also be caught as 'significant actions'. Although notification of these transactions is not mandatory, foreign investors frequently choose to notify these transactions and obtain approval in order to cut off the treasurer's powers. The most common transactions that are caught are purchases of Australian businesses (i.e., asset sales) with total assets of more than A$252 million and offshore transactions where the foreign target has Australian assets (including shares in an Australian subsidiary) of more than A$252 million. Again, investors based in certain treaty countries are in some cases subject to different thresholds.

5 Once the China–Australia Free Trade Agreement enters into force.

6 Sensitive businesses include media; telecommunications; transport; defence and military related industries and activities; encryption and securities technologies and communications systems; the extraction of uranium or plutonium; or the operation of nuclear facilities.

7 Different monetary thresholds apply depending on where the investor is based, and the type of land being acquired.

8 Non-government investors from certain treaty countries are subject to different thresholds.

While FIRB approval is principally a matter of concern from an M&A perspective (where ownership in the shares or assets are actually being transferred), it is also relevant in a debt finance context given that 'obtaining an interest' also extends to the grant of a security interest over such shares or assets.

In a finance context, there is an exception from this requirement if the interest is either held by way of a security or acquired by way of enforcement of a security, solely for the purpose of a money-lending agreement. This exception previously applied only to persons whose ordinary business included the lending of money; however, pursuant to the FATA amendments, this has been expanded to capture a subsidiary or holding company, a security trustee or agent, and a receiver or receiver and manager of an entity that holds or acquires the interest. This exception also applies to a 'foreign government investor', although in respect of an interest acquired by way of enforcement of a security a foreign government investor is restricted in the amount of time it can hold an asset (12 months in the case of an authorised deposit-taking institution (ADI) and six months in the case of a non-ADI, unless the foreign government investor is making a genuine attempt to sell the assets acquired by way of enforcement). It should be noted that the money-lending exception has more limited application where the security is over residential land.

Where the acquisition is not politically sensitive, these approvals are generally provided as a matter of course, although the need for FIRB approval should be considered where security is being granted over material Australian entities. However, as can be seen by the impact of the recent federal elections, these approvals can be difficult to obtain where the government shifts into caretaker mode.

It should also be noted that other government approvals can also be required to take security over certain types of assets (such as mining and resource interests) that are subject to separate regulation.

ii Interest withholding tax

Australia levies interest withholding tax (IWT) at the rate of 10 per cent on payments or credits of amounts of interest (or in the nature of interest) made by Australian borrowers to non-resident lenders. IWT is a final tax, as it is levied at a defined rate on the gross income of the non-resident lender (i.e., without deductions).

IWT can be reduced (including to zero) by the operation of Australia's network of double tax agreements (DTAs). Australia has negotiated DTAs with over 40 countries and, under DTAs with Finland, France, Japan, New Zealand, Norway, South Africa, Switzerland, the United Kingdom and the United States, there is no IWT for interest derived by a financial institution unrelated to the borrower (subject to certain exceptions). At the time of writing, the proposed DTA between Australia and Germany contains a similar 'treaty lender' concession from IWT, but the DTA is not yet in force.

Another frequently adopted means by which interest payments may be exempted from IWT is where the debt satisfies the 'public offer' exemption from IWT (contained in Section 128F of the Income Tax Assessment Act 1936 (Cth)). Broadly, the public offer exemption applies where the debt is publicly offered via one of several prescribed means, including where:

a the debt instrument is offered to at least 10 financiers, investors or security dealers in the course of operating in financial markets that are not known or suspected by the issuer to be associates of one another; or

b the debt instrument is offered to the public in electronic form.

Once the debt has been validly publicly offered, the securities are typically more marketable, as an incoming lender remains entitled to the benefits of the exemption from IWT (subject to certain criteria being met). This public offer process, and the associated protections contained in the finance documents, should be closely managed as the public offer test can potentially be failed for a variety of reasons: for example, where the issuer (or arranger acting as agent for the issuer) knew or had reasonable grounds to suspect that the debt instrument was being acquired by an offshore associate of the Australian borrower, unless the associate acquired it in the capacity of a dealer, manager or underwriter. There are additional requirements for the public offer exemption to apply to interest paid on debt under a syndicated facility agreement (including, that a minimum amount of A$100 million must be available for drawing by an Australian borrower at the time of the first drawdown under that agreement).

iii Thin capitalisation

Australia has a thin-capitalisation regime that can operate to deny income tax deductions for interest expenditure on overly geared Australian groups. Most Australian borrowers will rely on the safe harbour, which in broad terms allows for Australian assets to be funded by up to 60 per cent debt. In the context of an acquisition, these provisions allow for the funding of acquired goodwill.

In addition, there is an arm's-length debt test, which broadly allows Australian groups to be debt-funded up to the maximum amount a third-party lender would be willing to lend. However, this test is typically infrequently used (as it is an annual test, and therefore is contingent on the prevailing debt markets year on year). Following its review of the arm's-length debt test in 2015, the Board of Taxation endorsed the existing regime but recommended that certain concerns relating to the cost and complexity of the test be addressed by the ATO in the form of administrative guidance.[9] At the time of writing, no new guidance has been released.

III SECURITY AND GUARANTEES

i Common security packages

The Personal Property Securities Act 2009 (Cth) (PPSA) sets out the principles applicable to the grant and perfection of security interests in Australia, principles that should be relatively familiar to anyone who has had experience in a common law jurisdiction.

When enacted, the PPSA introduced a uniform concept of a 'security interest' to cover all existing concepts of security interests, including certain mortgages, charges, pledges and liens. It applies primarily to security interests in personal property that arise from a consensual transaction that, in substance, secures payment or performance of an obligation. It also applies to certain categories of deemed security interests, so that like transactions will

9 Source: Australian government, Board of Taxation, 'Review of the thin capitalisation arm's length debt test – A Report to the Assistant Treasurer', December 2014, and released on 4 June 2015.

be treated alike. 'Personal property' is broadly defined and essentially includes all property other than land, fixtures and buildings attached to land, water rights and certain statutory licences.

In a typical domestic secured lending scenario, security is most commonly taken by the relevant security providers entering into a general security deed (which replaces the former fixed and floating charge). Such an instrument can attach to 'personal property' (both tangible and intangible) and operates in a similar way to a debenture or security agreement. Accordingly, all-asset security can be obtained from corporate grantors simply and effectively.

In an acquisition context, the general security deed is often supplemented, where necessary, by a specific security deed over the shares of an Australian target (i.e., a share mortgage) granted by its special purpose vehicle or offshore parent. This is often a necessary part of the security structuring where restrictions on the provision of financial assistance (dealt with further below) mean that direct target security cannot be obtained on closing the acquisition. In each case, these security interests are supported by corporate guarantees, which are typically documented in the credit agreement.

To ensure priority and perfection, each of these security interests must be registered on the Personal Property Securities Register (PPSR), created under the PPSA, within 20 days of the date of the creation of the security interest. While not mandatory, registration ensures that the security interest retains its priority against subsequently registered interests and that it remains effective in the event of the insolvency of a corporate security provider.

It is possible (and advisable) for lenders to search the PPSR to determine whether there are any prior security interests registered against the relevant entities in the structure (including the Australian-domiciled holding companies and targets, together with any offshore parents of these entities).

Security can be granted over real property (both freehold and leasehold) by way of a registered real property mortgage. Such security is only generally sought where the real property in question has operational or economic significance. Unlike security interests that are dealt with under the PPSA, the grant of security over real property is dealt with on a state-by-state basis. However, from a practical perspective, there are few fundamental differences between the regimes in the various states. As with PPSR searches, the relevant land registries can, and should, be searched to determine what encumbrances or restrictions on title have been registered against the relevant property.

ii Issues with the grant of security

Financial assistance

Section 260A of the Corporations Act 2001 (Cth) (Corporations Act) imposes restrictions on companies providing financial assistance for the acquisition of their, or their holdings companies', shares. Financial assistance includes not only the grant of security, but also the provision of guarantees (among other things). While a transaction that breaches this restriction is not invalid, any person involved in the contravention of this provision is guilty of a civil offence. This liability can theoretically extend to the lenders.

The general prohibition on the provision of financial assistance is subject to certain exceptions. The most commonly utilised exception is the 'whitewash' process, which enables the shareholders of the company to approve the proposed financial assistance.

Given that an acquisition financing will invariably involve the grant of target security, the financial assistance rules are particularly relevant to this form of financing. For this reason, security over Australian target entities is generally granted within an agreed period post-closing (typically no less than 30 days). That said, this restriction does not impact the grant of security by any Australian incorporated special purpose holding company, or any offshore parent over its shares in an Australian-domiciled entity, which can still be provided on closing.

Corporate benefit

Under Australian law, directors owe a number of duties to the companies to which they have been appointed. These duties are enshrined in the Corporations Act, as well as arising under general law, and include a fiduciary duty to act in good faith in the best interests of the company. In a secured lending context, these duties often come under scrutiny in circumstances where a subsidiary is asked to guarantee the debts of its parent. Where the party obtaining the benefit of a guarantee or security knows or ought to know that the directors have not acted in the best interests of the company in providing such credit support, the guarantee or security will be voidable against that party. These obligations are often viewed in light of Section 187 of the Corporations Act, which enables a company to adopt a provision in its constitution enabling it to act in the best interests of its holding company (and in so doing, will be deemed to be acting in the best interests of the company itself).

Stamp duty

Mortgage duty payable on instruments that create a security interest over property situated in the state of New South Wales has been abolished with effect from 1 July 2016. This will reduce direct costs associated with the taking of security in Australia.

iii Australian insolvency regime and its impact on the grant of security

The Australian insolvency regime is codified in the Corporations Act and its associated regulations, and contains a number of provisions that can potentially affect a creditor to an Australian entity.

Under Australian law, transactions will only be vulnerable to challenge when a company does, in fact, enter into liquidation. Division 2 of Part 5.7B of the Corporations Act provides that a liquidator has the ability to bring an application to the court to declare certain transactions void. An administrator, in its report to creditors, may identify potential voidable transactions but is not in a position to challenge such transactions.

To be subject to challenge, such transaction would need to have been entered into while the company was proven to be cash-flow insolvent and be categorised as either:

a a director-related transaction;
b an unfair preference;
c an uncommercial transaction;
d a transaction entered into to defeat or delay creditors; or
e an unfair loan.

Each type of voidable transaction has different criteria and a different time threshold.

It is relevant that an unfair preference arises in circumstances where an unsecured creditor receives a greater amount than would have been received if such creditor had been required to prove for it in the winding-up of the relevant company, whereas transactions have been held to be 'uncommercial' where an objective bystander in the company's circumstances would not have entered into it.

In addition, the court has the power to determine a loan to be 'unfair' (and therefore voidable) if the economics of the loan could not be considered to be commercially reasonable. In practice, this provision has been seldom used, and the courts in Australian are reluctant to intervene unless the commercial terms greatly deviate from typical market terms (taking into account the financial situation of the company).

Upon the finding of a voidable transaction a court may make a number of orders, including requiring the transfer of the property back or the repayment of the benefit received.

IV PRIORITY OF CLAIMS

i Priority of claims on insolvency

Generally, unsecured claims in Australia will rank equally on a *pari passu* basis. Section 555 of Corporations Act provides that, unless the Corporations Act provides otherwise, all debts and claims in a winding-up rank equally, and if the property of the company is insufficient to meet them in full, such claims will be paid proportionately.

There are a number of exceptions to this general proposition (see Section 556 of the Corporations Act), including:

a expenses properly incurred by a liquidator or administrator in preserving or realising property of the company, or in carrying on the company's business (as well as other costs and amounts owed to them); and

b employee entitlements.

Sitting outside this regime are secured creditors, who will have priority over unsecured creditors. The security granted in their favour will entitle them to priority for payment of amounts outstanding from the proceeds and realisations of assets subject to such security interests. There is one exception to this, which is that employee entitlements have a statutory priority to the proceeds of assets subject to a circulating security interest (formerly, a floating charge) on realisation by a receiver or liquidator to the extent that the property of the company is insufficient to meet these amounts.

ii Subordination and the enforceability of intercreditor arrangements

Contractual subordination is a well-accepted tenet of secured lending in Australia; accordingly, intercreditor arrangements are commonly used in Australia to contractually clarify the relationship between two or more classes of creditor (including shareholder lenders and hedging counterparties).

Structural subordination is, however, less common (with a notable exception for holdco payment-in-kind instruments which have been gaining popularity in recent times). Accordingly, second-lien structures are able to be accommodated relatively easily from a local perspective, as demonstrated by the second-lien facility in the recent DTZ acquisition financing (and subsequent incrementals) where the contractual subordination was documented via a New York law-governed intercreditor arrangement.

Unlike that contained in the Loan Market Association suite of documents, there is currently no market standard intercreditor in Australia. A set of intercreditor principles (primarily applicable to leveraged transactions) has been circulated within the market, although they are seen as being particularly senior bank-friendly. Accordingly, a number of the provisions that these principles attempted to standardise (e.g., drag rights, standstill periods, mezzanine information rights and release provisions) remain hotly contested.

V JURISDICTION

i Consent to jurisdiction

Australian courts will generally respect the submission of an Australian entity to the courts of another jurisdiction, provided the choice of jurisdiction was not entirely unconnected with the commercial realities of the proposed transaction (and that there are no public policy reasons to deny such a submission).

ii Enforceability of foreign judgments

In Australia, the enforcement of civil judgments obtained in foreign courts is generally covered by two regimes. The first is under the Foreign Judgments Act 1991 (Cth) (FJA), which applies to certain specified courts in prescribed jurisdictions. Where the relevant court is not prescribed by the FJA, the enforceability of the relevant judgment will be dealt with by common law principles.

The FJA provides a framework, based on registration, for civil judgments made in prescribed foreign courts to be enforceable in Australia. This regime applies to judgments made by certain courts in prescribed jurisdictions, for example, certain Swiss, French, Italian and UK courts. Under the FJA, a judgment creditor of a relevant foreign judgment may apply to an Australian court for that judgment to be registered any time within six years after the last judgment in the foreign court. The judgment may be registered if it is final and conclusive for a fixed sum of money (not being in respect of taxes, a fine or other penalty), and is enforceable by execution in the relevant foreign country. Registration gives the judgment the same force and effect as if the judgment originally had been given in the Australian registering court (subject to certain exceptions). Special rules are also applicable to the enforceability of New Zealand judgments. The registration may be set aside if the foreign court did not have the necessary jurisdiction over the judgment debtor, either because the judgment debtor did not reside or carry on business in the jurisdiction when the proceedings were brought or did not otherwise submit to the jurisdiction of the court.

However, in certain jurisdictions (such as the United States) where Australia does not have the benefit of a treaty that provides for the reciprocal recognition and enforcement of judgments in civil matters, there is no statutory recognition or statutory enforcement in Australia of any judgment obtained in a court in such a jurisdiction. Instead, a judgment made by a court of the relevant jurisdiction can only be enforced in Australia under the common law regime.

Under that regime, any final, conclusive and unsatisfied judgment of the relevant court that has the necessary jurisdiction over the judgment debtor is *in personam* (that is, it imposes a personal obligation on the defendant) and is for a definite sum of money (not being a sum in respect of taxes or other charges of a like nature or in respect of a fine or other penalty) will be enforceable by the judgment creditor against the judgment debtor by action in the Australian courts (without re-examination of the merits of the issues determined by the proceedings in the relevant court). There are some exceptions, including where the proceedings involved a denial of the principles of natural justice, or the judgment was obtained by fraud or some other vitiating factor.

In respect of recognition of foreign insolvency judgments, Australia has enacted the UNCITRAL Model Law on Cross-Border Insolvency in the Cross-Border Insolvency Act 2008 (Cth).

VI ACQUISITIONS OF PUBLIC COMPANIES

The Australian corporations legislation (the Corporations Act) limits the manner in which a person can acquire voting securities in a listed Australian company or managed investment scheme, or an unlisted Australian company or managed investment scheme with more than 50 members, where this would cause that person's (or someone else's) voting power in the relevant entity to increase above 20 per cent or to increase (by any amount) from a starting point between 20 per cent and 90 per cent. There are two principal methods of acquiring control of an Australian publicly listed company or managed investment scheme: takeover bids or schemes of arrangement.

While there is no strict legal requirement for 'certain funds' financing, from a practical perspective, and owing to the increasing sophistication of both borrowers and lenders, financiers' commitments to fund are often provided on this basis (and indeed, this is desirable from an acquirer's perspective).

i Takeover bids

Chapter 6 of the Corporations Act provides the framework for takeover bids under Australian law. A takeover bid can be made on-market or off-market, and do not require the support of the target (i.e., either may be made on a 'hostile' or 'friendly' basis). For both on-market and off-market bids, a bidder must prepare and send to target security holders a document (known as a 'bidder's statement') that includes details of the offer, information about the bidder and certain other prescribed information. The target must respond by preparing and issuing a 'target's statement' including the target board's recommendation as to whether security holders should accept the offer, as well as any other material information.

An on-market bid is made through a broker and can only be used to acquire securities in a listed entity. On-market bids are far less common than off-market bids because they require the consideration to be 100 per cent cash and, importantly, cannot be subject to any conditions. Accordingly, it will often be the case that an on-market bid is not a viable option, e.g., because the bidder requires regulatory approvals or other conditionality.

An off-market bid essentially takes the form of a written offer to security holders to purchase all or a specified proportion of their securities. The consideration can take the form of cash, securities or a combination of the two. The offer must be open for acceptance for a period of not less than one month and not more than 12 months. All offers made under an off-market bid must be the same.

An off-market bid may be subject to any conditions the bidder chooses, other than conditions that are solely within the control of the bidder (or turn on the bidder's state of mind) and certain other prohibited conditions.

Typical conditions include those relating to the non-occurrence of certain statutorily prescribed events (including certain insolvency type events), the non-occurrence of a material adverse effect, the obtaining of any necessary regulatory approvals, the absence of any legal restraints or prohibitions to the acquisition completing, and the receipt of a minimum number of acceptances (usually 50 or 90 per cent, the latter corresponding to the threshold for the compulsory acquisition (or 'squeeze-out') of minorities).

Unlike the position in the United Kingdom, there is no legal requirement in Australia for 'certain funds' financing. However, the Corporations Act does prohibit persons from making an offer if they are unable, or are reckless as to whether they are able, to complete the offer. The Australian Takeovers Panel has separately indicated that it expects that where the bid is debt-funded, a bidder would have binding commitments from its lenders at the time of announcing its offer and would not declare its bid unconditional unless it is highly confident that it can draw down on these facilities (i.e., binding funding arrangements are documented in final form and commercially significant conditions precedent to draw down have been satisfied or there is no material risk such conditions precedent will not be satisfied).[10]

ii Schemes of arrangement

A scheme of arrangement is a court-approved arrangement entered into between a body (i.e., the target) and all, or a class, of its members. For a scheme to become binding on the target and its members (or the relevant class thereof), it must be approved by more than 50 per cent of members who vote on the scheme and those members must represent at least 75 per cent of the votes cast on the scheme. If these thresholds are met, the scheme is binding on all members (or all members in the relevant class), including those who vote against the scheme or do not vote at all. The typical operation of a scheme in the context of a control transaction is for the scheme to effect the transfer of target securities to the offeror in exchange for a specified consideration.

The consideration under a scheme can be structured such that security holders receive cash, securities or a combination of the two. There is more flexibility under a scheme with respect to the structure of the consideration as, unlike in a takeover bid, it is not necessary for all offers under a scheme to be the same, more easily facilitating differential treatment of security holders. Schemes can also be used to implement corporate restructures, demergers and debt-for-equity transactions.

A scheme of arrangement is essentially a target-driven process, with the target preparing the necessary security holder materials and seeking the necessary orders from the court. As such, a scheme requires the support of the target's directors and therefore is only a viable option in 'friendly' transactions.

There is no statutory requirement for 'certain funds'; however, as part of the court process, the offeror will be required to satisfy the court that it has sufficient funds to pay the scheme consideration and consummate the transaction. On a practical level, and in addition to giving the target's board comfort as to their ability to execute the transaction, this often results in offerors seeking certain funds funding from their financiers.

As with 'off-market' bids, schemes can be subject to conditions and it is common to see schemes being subject to the receipt of any necessary regulatory approvals, together with the non-occurrence of any material adverse effect with regards to the target. In addition, there are standard conditions relating to the necessary shareholder and court approvals.

10 Australian Takeovers Panel 'Guidance Note 14 – Funding arrangements'.

VII OUTLOOK

Activity within the acquisition and leveraged finance space is expected to continue being driven by infrastructure deals and M&A activity. Given the recent changes to FATA and the abolition of stamp duty, the prospect of further major regulatory reform in the near future is minor, accordingly, the forces that shape the next 12 months are likely to be market-orientated.

Chapter 3

AUSTRIA

Jasna Zwitter-Tehovnik[1]

I OVERVIEW

During the decade preceding the financial and economic crisis, Austria has developed into a buoyant market for both domestic and international M&A activity, with some of the peak years seeing in excess of 400 deals.

Compared with the crisis years, the most recent years seem to indicate some improvement in the market despite not having been able to deliver on the expectations. Cross-border deals still outnumber domestic activity by approximately two to one. The majority of international transactions involves international investors buying into the local market rather than vice versa. The most notable deals have been recorded in the real estate and banking sectors.

Traditionally, the common source for M&A transactions relating to Austrian investors has been loan finance. In recent times, this type of funding has almost exclusively taken the form of senior loan facilities, with commercial banks acting as the prevalent source of funding. Depending on the value of the particular deal, the structure will be bilateral or characterised by either primary or secondary syndication. Many of the syndicates typically include only domestic banks. In addition, the mechanism of risk or funded participation is frequently employed to reduce the risk of a single lender.

On the other hand, where a certain M&A activity pertaining to the Austrian market is part of a wider transaction or concerns a non-Austrian investor, the funding will most likely originate outside Austria and will not be characterised by the specifics briefly described above.

Given that financing by way of (senior) loan facilities is the prevalent form in acquisition and leveraged finance in our jurisdiction, in most cases this section does not highlight any aspects applicable to other types of finance.

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II REGULATORY AND TAX MATTERS

i Licensing

Austria has a relatively long list of services either requiring licensing as a credit institution in Austria or passporting of an equivalent licence obtained elsewhere in the European Economic Area (hereinafter referred to as a banking service). The Austrian authorities have traditionally taken a strict stance as to what qualifies as a banking service. Nevertheless, even nowadays a number of issues remain.

According to the Austrian Banking Act, concluding loan agreements as to monetary amounts, or providing monetary amounts as loans, is considered credit business (and as such a licensable banking service), provided it is being conducted on a commercial basis.

Generally speaking, granting a single loan facility to a borrower registered in Austria does not necessarily constitute a banking service regardless of whether such facility is secured or unsecured. Conversely, repeatedly providing loans to a borrower or different borrowers in Austria will trigger the licensing requirement assuming that the generation of income is intended by the lender. In addition, granting a single loan with the intention that such loan be followed by further facilities in the future will most probably also act as a sufficient trigger.

It is worth noting that the Austrian Administrative High Court has held that solely charging interest or fees as consideration or providing for the right of several drawdowns in respect of a facility does not suffice to constitute a banking service. Furthermore, there is no explicit intra-group exception from the licence requirement and, thus, the general regime would, in principle, equally apply to intra-group loans.

A possible breach of the licensing requirements results in the following:

a administrative fine of up to €100,000 payable by the lender;

b invalidation of every agreement on consideration payable to the lender (e.g., interest and fees); and

c invalidation of any ancillary security.

Of course, the need for an Austrian banking licence is only triggered if the territorial applicability of the Banking Act is given. For instance, if a non-Austrian member of the obligor group is designated as the actual borrower the Austrian Banking Act might not become relevant. Alternatively, the provision of the loan can be structured based on both the offer to enter into a credit relationship as well as the acceptance of this offer being made outside Austria. Nevertheless, the ambiguity mostly remains as to whether taking security in Austria on a commercial basis (whereas the granting of the loan is each time outside the scope of the Austrian banking law) on its own may constitute a banking service. Likewise, merely acting as a security trustee on a commercial basis also exposes the structure to certain risks. In both of those instances it is advisable to develop in advance a strong case for mere occasional activity (at least as regards Austria).

ii Tax matters

In terms of taxation, the Austrian tax regime allows for the formation of tax groups. The advantage is the offsetting of tax losses of one member against tax profits of another member. As a result, the interest expense related to an acquisition is deductible from the operating profits of the acquired Austrian operating group. The main requirement is that, as regards a direct or indirect subsidiary, there is a share exceeding 50 per cent of the registered capital and the majority of all voting rights are held throughout the particular fiscal year. Direct foreign subsidiaries of Austrian tax group members may also be included in an Austrian tax group; however, the total amount of foreign losses that can be utilised in any given year is currently limited to 75 per cent of the taxable income of the Austrian tax group members. Foreign losses that cannot be utilised in a particular year become part of the tax loss carry-overs of the head of the group.

The amortisation of goodwill for share deals has been abolished. In addition, Austrian tax relief is no longer granted for intercompany interest expenses where the recipient is subject to a low tax jurisdiction or a special tax regime. Specifically, the deductibility of interest payments made between related parties is no longer possible if the payments are not 'sufficiently' taxed or are not taxed at all at the level of the recipient, whereby a tax rate of 10 per cent at the level of the recipient is considered sufficient for these purposes. Last, any interest on debt incurred for the purpose of acquiring a share within a group of companies is not deductible.

The Austrian Administrative High Court ruled that the deductibility in connection with debt finance for an acquisition is not limited to interest in the strictest sense of the word but also encompasses commitment fees. Considering the course of the relevant proceedings, this argument may also be extendable to include a wide range of other financing costs, for example, other payments to the creditor or third parties such as brokers, notaries or lawyers.

Generally, no withholding tax is payable on loan interest paid to non-resident entities, but they are subject to Austrian corporate income tax if the loans in question are secured against Austrian real estate or other Austrian rights. This notwithstanding, any payments made to non-resident silent partners in an Austrian company are subject to a withholding of 25 per cent unless the rate is reduced or the payments are exempt under an applicable double taxation treaty.

As opposed to the interest payable under loans, if the debtor is resident in, has its registered office in, or is effectively managed in Austria, or is an Austrian branch of a foreign bank, then interest payments from an Austrian source under certain publicly issued bonds are also subject to withholding.

Under Austrian tax law, there are no explicit transfer pricing regulations available. Instead, Austria generally applies the OECD transfer pricing guidelines referring to the OECD model tax convention in order to define the local requirements as regards arm's length, the documentation standards, or penalties. Furthermore, the Austrian tax authorities have issued the Austrian transfer pricing guidelines setting out the authorities' understanding of inter-company business relationships with regards to their arm's-length classification (mostly based on the OECD transfer pricing guidelines).

iii Thin capitalisation

There are no explicit thin-capitalisation rules in Austria stipulating the minimum equity required by a company. Basically, group financing has to comply with general arm's-length requirements. Therefore, the appropriate ratio between an Austrian entity's equity and debt will mainly depend on the individual situation of the company (profit expectations, market conditions, etc.) and its industry.

Furthermore, under Austrian commercial law, a minimum equity ratio of 8 per cent is required. If this ratio falls below 8 per cent and the earning power (virtual period for debt repayment or redemption) of the company at the same time does not meet certain further requirements, a formal and public reorganisation process needs to be initiated.

III SECURITY AND GUARANTEES

i General

The legal framework in Austria provides for several different forms of security with highly developed and predictable rules as to their individual perfection and maintenance requirements. Likewise, the enforcement tends to be relatively straightforward and less cumbersome than in many other jurisdictions. Nonetheless, in practice it is customary to make use only of certain of those available options:

a mortgages;
b security assignments of accounts receivable or receivables under insurance policies;
c pledges over a share in a limited liability company;
d pledges over bank accounts;
e (corporate) guarantees; and
f suretyships.

Apart from guarantees and suretyships, the remainder of the security interests require not merely an agreement between the parties as to the creation of the particular security interest but also a specific method of perfection. Specifically, whereas a mortgage over real estate located in Austria requires registration with the Austrian Land Registry upon notarisation of the parties' signatures on the mortgage agreement, all other cases depend on the notification of the third party debtor (or, if applicable, the company the share in which is subject to security). Alternatively, where the security relates to receivables and such receivables are noted in accounting books of the grantor of security, an annotation in those books as to the creation of security can be employed.[2] In addition, all of these security interests as well as suretyships (although not guarantees as described below) are accessory to the creation and continued existence of the secured obligations. Accordingly, as a general rule, even an intermittent termination of the secured obligations will result in a termination of the security interest.

As opposed to the accessory forms of security, guarantees constitute an obligation independent of the secured obligations. Instead, the main issue here is to ensure that the wording of the security document sufficiently reflects this abstract nature. Otherwise, there is a risk that the security interest will be qualified as accessory suretyship. The primary indicators of an abstract guarantee are payment upon first request without reference to a particular secured obligation as well as lack of any kind of defences or other objections on the part of the grantor of security (e.g., relating to set-off or the legal relationship between the borrower and the creditor).

Moreover, to the extent a security interest could be construed as not referring to an obligation under a loan, a stamp duty of 1 per cent of the secured amount is payable in case of a suretyship but not on a guarantee. Similarly, the registration of a mortgage with the Austrian Land Registry triggers a fee of 1.2 per cent of the total secured amount.

Commonly, the security package will involve taking security over at least receivables, bank accounts, and shares, as well as guarantees.

2 Please note, however, that there is extensive case law available as to the requirements such annotation needs to comply with.

ii Limitations

On another note, when structuring a finance transaction certain restrictions apply in respect of upstream and sidestream security and guarantees: Austrian law is characterised by the rules on the maintenance of capital of both limited liability and joint stock companies.[3] As a result, an entity is not permitted to pay out (distribute) the capital comprising its equity to its shareholders (or, if applicable, any other affiliate) except (in particular) in the following cases:

a arm's-length transactions;
b distribution of the balance sheet profits subject to the statutory procedure;
c reduction of the registered share capital subject to a statutory procedure; and
d distribution of any remaining amounts following liquidation.

This prohibition covers not only monetary payments but also any other kind of transactions providing a benefit. Should a particular transaction be within the scope of the prohibition, it is null and void as regards the relevant entity and shareholder or affiliate and triggers liability for damages. In addition, the secured party is within its scope only to the extent it has known or should have known of the breach.[4]

As a consequence, any upstream or sidestream security or guarantee subject to the capital maintenance regime[5] is potentially exposed to the risk of ineffectiveness unless, generally speaking, the borrower as the benefiting party provides to the relevant provider of security an adequate (arm's length) consideration or if the finance party has concluded that the borrower is unlikely to default on its obligations or, respectively, the default would not expose the grantor of security to an existential risk, while the transaction is otherwise in the interest of the security grantor (corporate benefit).

Furthermore, the Austrian Joint-Stock Company Act sets out a prohibition on target companies being a joint-stock company from financing or providing assistance in the course of financing of the acquisition of their respective own shares or the shares of their parent entity. This prohibition is enforced regardless of whether the particular transaction concurrently constitutes a return of equity. Unlike the capital maintenance regime, the transactions breaching this provision remain valid yet are exposed to liability for damages.

Also, in syndicated lending transactions a security trustee is typically appointed for reasons of administrative convenience. Its role is to hold the security interests on trust for the benefit of all the lenders and any other parties entitled to benefit from the security. Such a structure results in the secured debt being significantly more tradable (an essential tool for ensuring compliance with the capital adequacy standards for banks). A syndicated lender may assign or novate part of the debt, while the security trustee continues to hold the relevant security, avoiding possible stamp duty and registration issues. However, the accessory types of security[6] must be held by the actual creditors. To address this, the covenant to pay the secured

3 Based on case law, these rules are equally applied to limited partnerships with merely limited liability companies or joint stock companies as unlimited partners.
4 In assessing this, a financial institution acting as the secured party is required to observe high standards of duty of care.
5 For example, the target or the target group act as obligors in respect of the acquisition finance. Please note that a pledge over shares subsequently held by a foreign company in any of the entities of the target group is outside the scope of the capital maintenance regime.
6 See above.

obligations to the lenders is supplemented by a parallel debt obligation. The borrower thereby acknowledges a separate debt to the security trustee for sums equal to the secured obligations under the finance documents as and when they fall due. All security is granted in favour of the security agent as parallel creditor, being accessory to and securing the parallel debt obligation. The secured debt remains the same throughout the life cycle of the loan facility, despite any transfer of debt by a lender.

Although there have been some attempts[7] at incorporating the concept of parallel debt into Austrian law, given the lack of relevant case law, scepticism and opposition continue to prevail in the legal theory.[8] The sceptics point to the general rule of contract law that, in order to validly enter into a contractual obligation, a commercial rationale (*causa*) for doing so needs to be evident and permitted under law.[9] The commercial rationale may, for instance, be found in buying an asset, giving a gift or resolving a dispute.[10] As a result, unless no accessory security interests are being employed, there is a noticeable risk to using the parallel debt covenant and security trustee structure governed by Austrian law.

iii Preferential treatment

Another critical issue to consider when structuring a deal is the risk of a security or guarantee being avoided. Generally speaking, this might occur if the security or guarantee is considered a preference or a transaction at an undervalue. The relevant legal framework is most notably set out in the Austrian Insolvency Act, which is applicable to situations with ongoing insolvency proceedings. In addition, the Austrian Avoidance Act also provides for the possibility of setting aside a security or guarantee in similar instances outside of pending insolvency proceedings.

A detailed analysis of the events triggering the risk of avoidance, in particular outside of pending insolvency proceedings, is beyond the scope of this article;[11] however, most importantly, the following actions may be appealed and declared invalid:

a discharge of an obligation or granting of security that has been made within 60 days prior to or after the occurrence of the inability to pay, the occurrence of over-indebtedness, or the filing of an application for the institution of insolvency proceedings (in any case within a period of one year prior to the institution of the insolvency proceedings) and a discharge or security of such kind or at such time was not due to the respective other party, provided that the respective other party has been treated preferentially, or a discharge or security of such kind or at such time was

7 Rabl, C 2012, 'Die Parallelschuld (Parallel Debt)', *Österreichisches Bankarchiv*, vol. 60, no. 6, pp. 674-681; Seeber, T 2014, '*Die Parallelschuld*' (Parallel Debt), *Österreichisches Bankarchiv*, vol. 62, no. 5, pp. 592–600.

8 See, for example, Apathy, P, Iro, G & Koziol, H (eds) 2012, *Österreichisches Bankvertragsrecht IX* [Austrian Banking Contract Law IX], Verlag Österreich, Vienna, pp. 395–396.

9 See the Austrian Supreme Court (OGH) in 6 Ob 152/05d.

10 OGH in 6 Ob 152/05d.

11 In any case, it needs to be taken into consideration that, according to the Austrian Supreme Court, the rules of the Austrian Insolvency Act concerning avoidance of contracts, in particular those setting out the requirements, are mandatory rules of law in relation to an Austrian person. Therefore, they would also apply in the case of a connection to another jurisdiction.

due to the respective other party but the intention of the insolvent debtor to treat the respective other party in a preferential manner has been known or should have been known to the respective other party; or

b discharge of an obligation or granting of security has been made after the occurrence of the inability to pay, the occurrence of over-indebtedness or the filing of an application for the institution of the insolvency proceedings (in any case within a period of six months prior to the institution of the insolvency proceedings) and, the discharge of an obligation or granting of security has been disadvantageous to creditors of the insolvent debtor and the respective other party had knowledge or should have had knowledge of the inability to pay, of over-indebtedness or of the filing of the application for the institution of the insolvency proceedings.

IV PRIORITY OF CLAIMS

In cases of insolvency, claims belonging to a limited number of categories take precedence in terms of recovery over most other claims. Such categories of claims are:

a costs of the insolvency proceedings;

b expenses incurred in connection with the maintenance, management and administration of the insolvency estate (including taxes, duties, customs duties and social security contributions;

c remuneration claims of employees in relation to the time following the institution of insolvency proceedings;

d claims by certain employees related to the termination of their employment relationship;

e claims by counterparties based on mutually unperformed contracts which have been upheld by the insolvency trustee;

f claims arising in respect of the dispositions by the insolvency trustee;

g claims based on unjustified enrichment of the insolvency estate; and

h remuneration payable to certain privileged creditor associations.

Outside of an insolvency situation, the lender and the borrower are free to assign differing ranks to different outstanding loan obligations by means of contractual arrangement. Market standard inter-creditor agreement wording can be employed and there is usually no need for any mechanism of structural subordination. This notwithstanding, the implications of the Austrian Act on Equity Substitution need to be considered.

According to the Austrian Act on Equity Substitution, any loan provided by a shareholder to its subsidiary (as defined below) during a 'crisis' will be deemed as substituting equity. A crisis situation can arise owing to (1) an inability to pay debts (e.g., when the entity ceases to make payments as they become due and payable), (2) the over-indebtedness[12] or (3) a need for reorganisation;[13] however, loans with a tenor of up to 60 days or loans provided before the crisis but granted during a crisis are outside the scope of this regime.

12 This is commonly construed as the value of the total assets of the company exceeding its total outstanding debt while no positive forecast can be made as to the future cash flow.

13 Defined as (i) the equity quota (the equity and untaxed reserves compared to the total assets) being below 8 per cent and (ii) the estimated liabilities repayment period exceeding 15 years,

As for the definition of a 'shareholder' for the purposes of the Austrian Act on Equity Substitution, only those persons with a share of at least 25 per cent, with the majority of voting rights, or exercising a decisive influence over the company, are within its scope. Importantly, even a third-party lender such as a financial institution can be considered a 'shareholder' by virtue of factual circumstances, by exercising rights beyond those commonly granted to a lender in connection with a finance transaction.

If a loan is deemed equity substituting, a ban on its repayment to the relevant shareholder is imposed for the duration of the crisis. Where the shareholder was not the actual lender but rather only secured a loan provided by a third party, that third party will normally have the right to claim repayment from the borrower, except if the third party has been aware of the crisis at the time of the granting of the loan. In the latter case, as long as the crisis is still ongoing, the lender would be required to primarily enforce the security and claim recovery from the actual borrower only in respect of the remaining outstanding amounts.

V JURISDICTION

i Choice of law

The choice of law and other conflict-of-laws matters are subject to, as regards contractual aspects, the Rome I Regulation[14] and, in relation to the non-contractual relationships, the Rome II Regulation.[15] As a consequence, there is no general requirement for a transaction to have a link (of certain quality) to any particular jurisdiction in order to be able to make applicable the law of that jurisdiction to the transaction. The choice can be made in respect of the contract as a whole or only a certain part thereof.

Nevertheless, it needs to be noted that the choice of law can only relate to the contractual aspects. Matters such as applicable insolvency law or company law are outside the scope of the regulations. In addition, the Rome I Regulation explicitly excludes arbitration agreements and agreements on the choice of court, certain matters related to trusts or agent–principal relationship, and the obligations arising out of dealings prior to the conclusion of a contract, from its applicability.

Another important feature of the Rome I Regulation are the limits set on the parties by the public policy of the forum and the overriding mandatory provisions of the forum or, possibly, of the law of the country where the obligations arising out of the contract have to be or have been performed (insofar as those overriding mandatory provisions render the performance of the contract unlawful). The latter are provisions the respect for which is regarded as crucial by a country for safeguarding its public interests, such as its political, social or economic organisation, to such an extent that they are applicable to any situation falling within their scope, irrespective of the law otherwise applicable to the contract under this regulation.

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provided that this has been apparent from the latest annual accounts, would have been apparent from duly prepared annual accounts, or the lender otherwise has knowledge thereof.

14 Regulation (EC) No. 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations.

15 Regulation (EC) No. 864/2007 of the European Parliament and of the Council of 11 July 2007 on the law applicable to non-contractual obligations.

ii Jurisdiction

As for a submission by an Austrian company to the jurisdiction of a foreign court, this will generally be recognised in finance transactions in Austria, assuming validity of the agreement on the submission and non-violation of any rules on exclusive jurisdiction. In most cases, the Brussels Ia Regulation[16] will apply. Outside the scope of applicability of the Brussels Ia Regulation, a sufficient relation of either the parties or the object of the dispute to the chosen jurisdiction may be required.

It is quite common for Austria-related transactions to be subject to arbitration agreements. These, in particular the issues as to whether or not an arbitration agreement is null and void, inoperative or incapable of being performed, are not subject to the rules laid down in the Brussels 1a Regulation, regardless of whether the court decided on this as a principal issue or as an incidental question. Rather, in the majority of cases, the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, done at New York on 10 June 1958, will apply in that regard.

The recognition and enforcement of foreign judgments and arbitral awards is subject to the Brussels Ia Regulation, the New York Convention, or, respectively, Austrian domestic laws or (bilateral) international agreements on enforceability. According to the Brussels Ia Regulation, a judgment given in an EU Member State must be recognised in any other Member State (excluding Denmark) without any special procedure being required. Likewise, a judgment given in an EU Member State that is enforceable in that Member State is enforceable in the other EU Member States without any declaration of enforceability being required. As opposed to that, the New York Convention provides for the possibility of certain limited defences. As regards all other instances, in the absence of an applicable international agreement on enforceability, there is no automatic enforceability. Depending on the circumstances, the Austrian courts would decline the recognition and enforceability or re-examine the merits of the case.

Given the absence of applicable international agreements on recognition and enforceability with the US and Russia respectively, the standard market practice when dealing with those two jurisdictions is to opt for arbitration.

VI ACQUISITIONS OF PUBLIC COMPANIES

i Certain funds requirements

The Austrian Takeover Act imposes certain obligations on the offeror. Section 4(1) of the Austrian Takeover Act explicitly stipulates that the offeror may announce a bid only after ensuring that it can fulfil in full any cash consideration, and after taking all reasonable measures to secure the implementation of any other type of consideration. In addition, the offeror has to appoint a qualified expert, independent from the offeror, who must confirm

16 Regulation (EU) No. 1215/2012 of the European Parliament and of the Council of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters.

that the offer is in compliance with the provisions of the Austrian Takeover Act, and in particular, with regard to the consideration offered, that the offeror has the financial means to fulfil the bid.

ii Mandatory offers triggered by a share pledge or enforcement of a share pledge

In general, mandatory offers are governed by the Austrian Takeover Act. A mandatory takeover offer is required if the offeror acquires a 'controlling interest' in the target company. A person holds a controlling interest if he or she holds a direct or indirect interest in the target company, exceeding 30 per cent of the voting rights attached to the shares with permanent voting rights. Such mandatory offers require that the price to be offered to the remaining shareholders must at least equal the average price paid for the shares during the previous six months prior to the acquisition of the controlling interest.

In a case of the enforcement of pledged shares in a public company, the mandatory offer obligation is triggered in the same way as in any other acquisition. This scenario is common in acquisition financing when a credit institution, following the borrower's default, enforces the share pledge and thus acquires the shares in the public company.

A pledge of shares in a public company does not itself trigger the duty to mandatory offer since the pledgor remains as the beneficial owner of the pledged shares and thus is entitled to exercise the voting rights attached to such shares.

In a case of transfer of shares by way of security, the voting rights may be theoretically exercised by the transferee, however, in practice the transferee is instructed by the transferor on how to exercise the voting rights so that such shares will not be attributed to the transferee and thus he or she will have no duty to mandatory offer.

iii Minority squeeze-outs

The Austrian Squeeze-Out Act provides a procedure under which a majority shareholder may squeeze out all minority shareholders. A shareholder (including any affiliated companies) holding at least 90 per cent of the capital with voting rights and at least 90 per cent of the voting rights qualifies as a majority shareholder under the Austrian Squeeze-Out Act. The majority shareholder may require the holders of all remaining shares to sell the shares to the majority shareholder. The necessary shareholders' resolution on the squeeze-out requires a simple majority vote.

The majority shareholder must offer to pay adequate cash compensation for the acquired shares to the minority shareholders. The squeeze-out of minority shareholders becomes effective with the registration of the squeeze-out with the Austrian companies registry. Upon such registration, the shares of the squeezed-out minority shareholders are automatically transferred to the majority shareholder. The amount of the cash compensation can be challenged in a review proceeding, to be commenced after the squeeze-out is implemented.

iv Other permitted conditionality

Generally speaking, the parties involved in an acquisition transaction can make the offer subject to certain conditions; however, for listed public companies, the Austrian Takeover Act stipulates that an offer may only be conditional if it is objectively justified. Such objective justification is given if the respective conditions are based on the fulfilment of certain legal obligations of the offeror or if the fulfilment of the conditions does not solely depend on the subjective decision of the offeror.

On the other side, a public offer cannot be made conditional on financing. The offeror must be able to settle the offer consideration when it is due and payable. Therefore, the offeror's financial adviser must confirm in the offer documentation that the offeror has sufficient funds to pay the consideration. The financial adviser will therefore review the financing arrangements of the offer very carefully, in particular the provisions of external financing.

v Disclosure requirements for financing terms including flex and fees

A takeover offer in Austria typically consists of an offer by the bidder to all shareholders of the target company to acquire their shares. The Austrian Takeover Act sets out minimum requirements for the offer document. Besides other required details, the bidder has to disclose in the offer document the conditions for the bid financing.

The bidder must disclose whether it will finance the takeover with its own funds or will make use of debt financing. In the case of the latter, the bidder has no obligation to provide the name of the financing credit institution in the offer document. The bidder is free, however, to name the lender – this is recommended for the benefit of the bidder in the event of greater financing volume.

If an arrangement exists between the bidder and the financing institution that makes the interest payments of the bidder conditional on the cashflows of the target company, such arrangement has to be disclosed in the offer document.

vi Confidentiality requirements

In general, during takeovers of listed companies, any intention of the offeror to make a public offer for a listed company or to take steps resulting in an obligation to launch a bid has to be kept confidential to prevent premature disclosure. In practice, confidentiality agreements are often entered into when negotiations between the parties begin. Since offerors have to oblige all participating parties to assure confidentiality, they usually prescribe internal rules to keep all communications confidential.

The confidentiality obligation under the Austrian Takeover Act applies also to financial arrangements, such as debt issuance and syndication.

VII OUTLOOK

For the remainder of 2016, no significant change in recent trends is expected; M&A activity will most probably remain moderately positive.

Some activity will certainly be attributable to the repositioning of the local banking sector. Likewise, due to the ongoing intensive efforts of restructuring their non-performing asset portfolios, it is rather likely that local sources of finance will remain conservative when considering new finance opportunities or novel forms of financial products. In other words, new deals will most likely continue to be characterised by restrictive (financial) covenants and extensive security packages.

Possibly, the share of finance originating in Austria will reduce in the coming years as Austrian investors continue to scale back their involvement abroad, in particular in Central and Eastern Europe.

Chapter 4

BELGIUM

Jacques Richelle, Sander Buysse and Eric-Gérald Lang[1]

I OVERVIEW

Benefiting from solid economic growth and an abundance of liquidity, in 2015 the Belgian leveraged and acquisition market experienced a surge in activity. Despite several headline news deals, most activity is concentrated in the small and mid-cap transactions.

Most acquisition and leveraged financing deals are arranged and financed by the largest Belgian banks, with one or a few foreign banks participating in the club or syndicate.

Belgian debt capital markets, private placements in particular, have been very active and certain acquisitions have been financed by the issue of notes as well, in many cases alongside bank financing. Notable examples from last year are the bond issuance by Solvay for an amount of €4.7 billion to finance its acquisition of the American company Cytec Industries and the bond issuance by AB InBev for an amount of €3.5 billion to (partly) finance its takeover of SAB Miller.

There are no Belgian debt funds and foreign funds are not active in Belgian transactions.

Bank financing documentation is most often drafted in English (even for purely Belgian transactions). It is usually based on the Loan Market Association standards. It may be governed by English law, for any transaction that may be syndicated internationally, or by Belgian law (even for club deals involving certain foreign banks).

II REGULATORY AND TAX MATTERS

i Licensing – No banking monopoly

In Belgium, no banking licence is required to grant loans to commercial entities. No regulatory restrictions apply to lenders when participating in leveraged and acquisition financings.

1 Jacques Richelle is a partner and Sander Buysse and Eric-Gérald Lang are associates at Strelia.

ii Sanctions, anti-corruption and anti-money laundering

Economic or trade sanctions or other restrictive measures may be enacted, administered or enforced against credit institutions, notably by the Office of Foreign Assets Control in the US, the United Nations Security Council, the European Union or national authorities.

Belgian banks, and in particular BNP Paribas Fortis (as a consequence of the huge fine imposed by the US Department of Justice on BNP Paribas in 2014), have become more sensitive to these issues and request detailed representations and warranties and undertakings in this respect.

Leveraged finance transactions are subject to the general Belgian anti-corruption and anti-money laundering laws and regulations, without any specific transparency requirements being applicable.

The Belgian anti-corruption regulations[2] implement international as well as European frameworks or rules.[3]

The Belgian anti-money laundering law[4] implements the European Directive of 2005.[5] Credit institutions should be mindful of the 'know your customer' requirement applicable to any transaction in excess of €10,000.[6]

iii No other regulatory concerns

In Belgium, no legislation prohibits or controls any investment, national or foreign, into any sector for the purpose of protecting the Belgian national interest.

There are currently no specific exchange controls for the transfer of funds abroad.

iv Tax issues

The main tax structuring issues affecting acquisition financing transactions relate to the deductibility of interest and the avoidance of withholding tax on the service of the debt.

Interest deduction

Interest is generally deductible from the Belgian tax base of the borrower, to the extent it accrued in the relevant tax period, was borne to obtain or retain taxable income and meets the arm's-length standards.

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2 Law of 10 February 1999 on the punishment of corruption and Articles 246–252 of the Belgian Criminal Code.

3 Belgium is a party to the Criminal Law Convention on Corruption and the Civil Law Convention on Corruption of the Council of Europe, the United Nations Convention against Corruption and the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. The European Council Framework Decision 2003/568/JHA of 22 July 2003 on combating corruption in the private sector is applicable in Belgium.

4 Law of 11 January 1993 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing.

5 Directive 2005/60/EC of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing, which was recently replaced by Directive 2015/849 of 20 May 2015 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing.

6 Article 7 of the Law of 11 January 1993.

In very particular circumstances only, interest on debt financing will not be deductible, including:

a Anti-thin capitalisation rule for intragroup loans and loans from tax-privileged entities: interest paid on intragroup loans or loans from tax-privileged entities are not deductible above a 5:1 debt-to-equity ratio.[7] The concept of 'group' refers to all companies that are connected within the meaning of the Belgian Companies Code. A series of exceptions apply, including on publicly issued bonds, loans from credit institutions and loans from leasing companies. Back-to-back arrangements aiming at circumventing the rule may be disregarded in certain circumstances.[8]

b Loans from tax-privileged entities: notwithstanding the above rules, interest payments to tax-privileged entities are only tax deductible if made (1) in the framework of genuine and sincere transactions and (2) to entities other than artificial arrangements.[9]

c Payments to entities in certain listed tax-havens: in addition to other anti-abuse provisions, direct or indirect payments to recipients located in certain listed jurisdictions are not tax deductible if not duly and timely disclosed using a special form.[10] This disclosure only applies when payments exceed an aggregate amount of €100,000 per tax year. Targeted jurisdictions are those published by Belgian Royal Decree and those mentioned on the OECD 'Blacklist', including at the moment Luxembourg and Cyprus.

d Loans from individual shareholders and corporate bodies: interest on loans from individual shareholders and corporate bodies are not deductible above a 1:1 debt-to-equity ratio.[11] Exceptions apply to publicly issued bonds, loans from companies subject to Belgian corporate income tax and loans from recognised cooperative companies.

Withholding tax

A withholding tax at a rate of 27 per cent is normally due on interest payments, subject, however, to exemptions or reductions as may be available under applicable domestic or tax treaty provisions.

Belgian domestic provisions provide for significant withholding tax exemptions, which may be particularly relevant in acquisition financings:

a interest paid by professional investors on loans from financial institutions within the meaning of the BITC, i.e., Belgian resident credit institutions (or Belgian branches of foreign credit institutions) and credit institutions (or branches of foreign credit institutions) established within the European Economic Area or within a country having a double tax treaty with Belgium;

b interest paid on Belgian registered bonds subscribed by a non-resident investor, provided that the latter is not tax-privileged or is not more than 50 per cent owned by Belgian residents, provided further that the bonds are held during the full interest period;

7 Article 198, Section 1, 11° of the Belgian Income Tax Code (BITC).

8 Contrary to certain other jurisdictions, the anti-thin capitalisation rules do not apply by the mere fact that a group company guarantees funding by a third party.

9 Article 54 of the BITC.

10 Articles 198, Section 1, 10° and 307 of the BITC.

11 Article 18 of the BITC.

c interest paid by certain listed companies (or their subsidiaries) on loans to non-resident investors, provided that the bonds are held during the full interest period;

d interest paid to UCITS, collective investment undertakings investing in receivables, and public alternative investment funds, based either in Belgium or within the EEA; and

e interest paid on securities registered with the X/N clearing system supervised by the National Bank of Belgium, in particular to non-resident investors (without subject-to-tax or holding conditions).

Next to these exemptions, certain double tax treaties provide for an exemption on interest payments to, for instance, enterprises or financial enterprises located in the other treaty state.

Treaty exemptions with Germany, Luxembourg and the Netherlands are commonly used, typically leading to financing structures involving a Luxembourg or Dutch lender.

In any case, the above exemptions are subject to specific requirements and formalities that are to be carefully examined in light of the particular circumstances.

Tax consolidation of the acquisition debt

Belgian tax law does not provide for any tax consolidation system, precluding from compensating acquisition and financing expenses at the level of the acquisition vehicle and operational profits of the target companies. Cash upstreaming, reorganisation or other debt pushdown mechanisms are to be analysed on the basis of the specifics of each transaction.

III SECURITY AND GUARANTEES

i Financial assistance

Belgian limited liability companies are only allowed to grant financial assistance (by way of loans, guarantees or security) for the acquisition or the subscription of their own shares by a third party provided that certain stringent requirements are met (including the limitation of the financial assistance to the amount of distributable reserves, fair market conditions to be determined by the board of directors, shareholders' approval and the publication of an extensive report by the board of directors). In practice, these requirements are never met.

These requirements do not apply to the financing of the acquisition of parent, sister or subsidiary companies.

ii Corporate purpose

Any credit support (by way of guarantee or security interest) must be within the corporate purpose of the company as specified in its articles of association. The wording of purpose clauses in the articles of association is usually sufficiently wide. If not, it can be changed by the shareholders' meeting subject to certain formalities. Such a procedure may take a few weeks.

iii Corporate benefit and guarantee limitations

Any credit support granted by a Belgian company must be part of a transaction that, taken as a whole, is in its (direct or indirect) corporate benefit, failing which its credit support may be void. The concept of 'group benefit' does not exist under Belgian law.

The Belgian Supreme Court recently held that corporate benefit is determined by the collective profit objectives of the current and future shareholders,[12] which may be interpreted as allowing the company to take more clearly into account the interest of the group to which it belongs. However, this decision may not be decisive and the interest of other stakeholders may also need to be taken into account.

In order for a guarantee or security interest by a Belgian company of obligations of other group companies or obligors to be considered to fall under its corporate benefit, it is usually considered that the following conditions must be met:

a the guarantor must derive an actual (direct or indirect) benefit from the transaction; downstream guarantees are considered to meet this condition, except in exceptional circumstances; the analysis is more difficult for sidestream and upstream guarantees; and

b the guaranteed amounts must be commensurate with the direct or indirect benefit derived from the transaction and the financial capabilities of the guarantor or value of its assets.

Therefore, finance documents usually include guarantee limitations in respect of Belgian guarantors. The limitation may be based on (a combination of) various elements, including a percentage of net assets, the amount of the financing downstreamed to the guarantor and a minimum fixed amount.

iv Misuse of company assets

Officers of a Belgian corporation who knowingly use its assets or credit directly or indirectly for personal gain (which could include acting in a way that favours another entity of the group) and in a way that is contrary to its interests, risk personal criminal liability.[13]

Lenders in acquisition financings should be aware that, in certain circumstances, they may be considered as accomplices to such criminal offence.

v Types of security interest available in Belgium

Under Belgian law, no general form of security exists. For each type of asset, a specific form of security interest, with its own requirements, will be vested. Security interests in Belgian acquisition financings are most commonly granted over the business as a going concern, shares, bank accounts, receivables and intellectual property. Security interests may also be taken over real estate or stock and inventory where these assets are of particular relevance, but costs and formalities may be cumbersome.

Pledge over business assets

The closest in form to a floating charge under Belgian law is a pledge over business assets. The pledge covers the assets that constitute the business of the pledgor including the clients, goodwill, commercial name and signs, commercial organisation, trademarks, patents, knowhow, rights under leases, furniture, commercial records, equipment and vehicles. Ships, land and buildings are excluded and only 50 per cent of the inventory value may be covered by the pledge (the remaining 50 per cent can be the object of a separate specific pledge

12 Cass. 28 November 2013.

13 Article 492-bis of the Belgian Criminal Code.

agreement – see below). The pledgor may keep on running its business and may sell the assets in the ordinary course of business (i.e., with proper business justification). Fraudulent disposition of assets, however, may lead to criminal sanctions.

The pledge must be registered with the mortgage registrar of each judicial district in which the pledgor has a place of business and such registration is valid for 10 years. The pledge is subject to registration tax and other costs equal to 0.5 or 0.6 per cent of the secured amount. However, a much cheaper – but unregistered – power to pledge business assets may be accepted by lenders, as an alternative or, in most cases, in addition to a pledge over business assets registered for a limited amount. Such power will only provide security once it has been exercised and a pledge over business assets has been registered.

The pledge may only be granted for the benefit of EU-licensed credit institutions or specific types of financial institutions. It may, however, be subsequently assigned (together with the claim) to any other type of creditor.

Pledge over shares

The perfection of a pledge over shares will depend on the nature of the shares (registered shares, dematerialised shares or shares held in the Euroclear system).

In principle, the rights inherent to the shares, such as voting rights, participation in dividends or new issues, will be retained by the pledgor; however, the pledge agreement will usually contain certain restrictions on the pledgor's exercise of these rights and typically provide that the pledgee may exercise such rights in the case of an event of default.

Pledge over receivables

A security interest over Belgian law receivables (including, for example, the purchaser's rights under warranties and indemnities granted by the seller under the share purchase agreement) is taken by specific pledge or, provided the receivables are specifically covered in the agreement, as part of a pledge over business assets (or, as often occurs, by both means).

A pledge over receivables is valid between parties and enforceable against third parties (other than the debtor of the receivables) as from the date of the pledge agreement. To be valid against the debtors of the receivables, the debtors must be notified of, or acknowledge, the pledge.

A pledge can cover future receivables provided they are sufficiently identifiable and determinable. Otherwise they will need to be separately pledged as they arise.

Special attention must be paid to conflict of laws rules where the debtor of the pledged receivables is located abroad.

Pledge over bank accounts

As a pledge over a bank account is generally viewed as a pledge over a receivable (i.e., the claim on the bank for the funds standing to the credit of the account), it can be included in the pledge over receivables agreement. An acknowledgement by the bank holding the pledged account is required in order to protect the pledgee against the rights of the Belgian account banks, which, based on their general terms and conditions, usually benefit from a pledge over the accounts and other similar rights, which must be waived in favour of the pledgee. The pledgor may continue to operate the pledged account, subject to contractual restrictions, if any.

Pledge over intellectual property rights

Security interests over certain intellectual property rights are taken by specific pledge or, provided the intellectual property rights are specifically covered in the agreement, as part of a pledge over business assets (or by both means). Specific perfection requirements apply.

Pledge over moveable assets

Security over moveable assets (including inventory) can be taken by specific pledge or as part of a pledge over business assets (but only up to 50 per cent of the inventory value).

In practice, special care must be taken when setting up a specific pledge over moveable assets. It requires the transfer of the pledged assets out of the control of the pledgor, which is not always feasible. The control over the pledged assets must be exercised by the pledgee or a mutually agreed third party.

Future moveables may be pledged, but the pledge will not be perfected until the moveables are in possession of the pledgee or third party.

Mortgage

A mortgage over real estate must be created by means of a deed drawn up by a notary public and must be registered in order to be valid against third parties. It is valid for 30 years as from registration and is renewable.

The creation of a mortgage is expensive. The mortgage is subject to registration tax and other costs equal to approximately 1.5 per cent of the secured amount (including notarial fees). However, a much cheaper – but unregistered – power to mortgage is usually accepted by lenders, as an alternative or, in most cases, in addition to a mortgage registered for a limited value. Such power will only provide security once it has been exercised and a mortgage has been registered.

Upcoming changes to the rules on security interest over moveable assets

A new Belgian law on security over moveable assets,[14] which is expected to come into force in January 2017, will affect some of the existing security interests, in particular the pledge over business assets and the pledge over moveable assets.

The most important new element is that a new type of security interest will be created, i.e., a register pledge. Pursuant to this new form of security, all moveable assets, tangible and intangible, in whole or in part, can be pledged by private agreement without the need for these assets to be taken out of the control of the pledgor. This new pledge will replace the current pledge over business assets and be more flexible in various ways. The pledge will be valid against third parties by registration in a newly established National Pledge Register. This registration will be valid for a renewable period of 10 years. The success of this new security interest will depend upon a number of elements that are still uncertain at the moment, such as the cost of the registration.

Other notable changes include the possibility to pledge the entirety of a pledgor's inventory under the new register pledge and the possibility to grant the new register pledge in favour of entities other than credit or financial institutions (unlike the current pledge over business assets).

14 Law of 11 July 2013 on security over moveable assets.

vi Enforcement of security interest

General rules

All Belgian security interests may be enforced, with a court's prior approval, by sale of the mortgaged or pledged assets at public auction or, for pledged assets, direct sale pursuant to the process decided by the court.

In addition, based on the implementation of the Financial Collateral Directive:

a enforcement of pledges over shares (or other financial instruments) may, without a court's prior approval, take the form of a sale or, provided the parties have expressly agreed thereto and have provided a contractual mechanism for the valuation of the relevant shares (or other financial instruments), appropriation by the pledgee; and

b enforcement of pledges over bank accounts occurs, without the court's prior approval, by the application of the credit balance on the secured debt, based, where applicable, on the exchange rate or determination mechanism agreed between the parties.

From the entry into force of the new Belgian law on security over moveable assets, with the permission of the pledgor, granted in the pledge over business agreement or register pledge agreement or at a later stage, the pledgee will, subject to satisfying certain conditions, be able to appropriate the pledged assets, without prior court approval.

Stay of enforcement against a grantor subject to Belgian insolvency proceedings

The lenders retain the right, in the case of insolvency of the debtor or security grantor, to initiate or continue proceedings, but any enforcement procedure is automatically suspended for a maximum period of 60 days while creditors' claims are checked. In addition, enforcement procedures by the lenders may be suspended by the court, at the request of the receiver, for a period of up to one year from the declaration of insolvency, in order to allow the receiver to proceed himself or herself with the sale.

In case of judicial restructuring, an initial 'cooling-off' period of a maximum of six months may apply during which the lenders can be prevented from enforcing their security. This period may be extended to 12 (or in exceptional circumstances 18) months in total. However, pledges over receivables set up prior to the opening of the judicial restructuring procedure are not covered by the moratorium.

vii Security agents and parallel debt

A security interest must be granted to the actual creditors of the secured liabilities, not to a person acting on account of the creditor or group of creditors (i.e., security agent or security trustee). It may be granted to future creditors.

However, a Belgian or foreign security interest over financial instruments (including shares) or bank accounts may be granted in favour of a representative of a fluctuating body of creditors, acting in its own name but for the account of the creditors or beneficiaries, provided these beneficiaries may at all times be determined on the basis of the pledge agreement. This allows the use of a security agent for this type of security. However, it is highly uncertain that Belgian law would recognise a trustee for this purpose (as the concept of trustee does not exist under Belgian law). The representative must not necessarily be a creditor itself. The changes in beneficiaries will not affect the validity, enforceability and ranking of the collateral. The representative exercises all rights that would normally be exercised by the beneficiaries.

A specific problem arises for mortgages and pledges over business assets: the names of the beneficiaries must be mentioned in the mortgage registers. Therefore, any future change of lender or secured party should be registered as well, which is cumbersome and entails certain costs.

In order to avoid this problem, it is customary to set up a 'parallel debt' in favour of the security agent. Pursuant to the parallel debt structure, the security agent (parallel debt creditor) becomes the holder of a direct claim against the obligors, which may be secured by the granting of security in its favour.

IV PRIORITY OF CLAIMS

i Preferred creditors and claims

Belgian law grants priority to the payment of a number of preferred creditors, including employees, officials appointed by the insolvency court, certain secured creditors and the Belgian state (in respect of taxes and social security contributions).

ii Intercreditor agreement

Intercreditor agreements in the context of Belgian leveraged financings tend to be based on LMA standards. No specific Belgian rules are relevant in this respect.

V JURISDICTION

The choice of a foreign law to govern agreements to which a Belgian entity is a party will be recognised by Belgian courts pursuant to the Rome I Regulation[15] in relation to contractual obligations and (if applicable) the Rome II Regulation[16] in relation to non-contractual obligations.

The submission by a Belgian entity to the jurisdiction of a foreign court will also be recognised as valid and binding and may not be unilaterally revoked by the Belgian courts, provided it is effective in such foreign courts under the laws of such jurisdiction and if not made with the intention of avoiding the application of mandatory provisions of Belgian law or of the laws of another relevant jurisdiction.

A final and conclusive judgment obtained in a properly selected foreign court from another EU Member State against a Belgian party for a sum of money due under the relevant finance documents would be enforced by the courts of Belgium without re-examination of any aspect of the litigation, pursuant to Regulation (EU) No. 1215/2012.[17]

Subject to an action for *exequatur* brought before the competent Belgian court, a final judgment for a sum of money due under the relevant finance documents obtained against a

15 Regulation EC No. 593/2008 of 17 June 2008 on the law applicable to contractual obligations.

16 Regulation EC No. 864/2007 of 11 July 2007 on the law applicable to non-contractual obligations.

17 Regulation EU No. 1215/2012 of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters.

Belgian party in the courts of a properly selected foreign country that is not an EU Member State would also be recognised and enforceable by the Belgian courts without re-examination of the matter.

Asymmetrical jurisdiction clauses, pursuant to which one party submits to the exclusive jurisdiction of a court and another party has a discretionary option to choose any competent jurisdiction, are common in Belgian law finance documents. However, the impact under Belgian law of the decision of the French Supreme Court holding such clause invalid[18] is unclear at this stage.

VI FINANCING ACQUISITIONS OF BELGIAN LISTED COMPANIES

Several particularities must be taken into account in the leveraged financing of an acquisition of a Belgian-listed company.

Each tender offer must cover all shares of the listed target,[19] and financing from a Belgian credit institution must be available to purchase all the shares of the listed target that are not already owned or controlled by the initiator of the tender offer.[20] This is usually evidenced by the delivery of a certificate from the relevant Belgian credit institution to the Belgian Financial Services and Markets Authority.

However, Belgian law does not require the disclosure in the prospectus of the leveraged and acquisition financing or any of its terms.

Where a shareholder crosses a 30 per cent threshold of share capital or voting rights in a Belgian-listed company, it is required to launch a mandatory tender offer for all the outstanding shares.[21] Similarly, lenders enforcing their share pledge by way of appropriation over a number of shares exceeding the same threshold would themselves have an obligation to launch a mandatory tender offer.

VII OUTLOOK

Following a very active year, the M&A activity in the Belgian market is expected to return to its long-term average volume in 2016 and 2017. Especially for small and mid-cap transactions, the outlook remains positive, as the number of Belgian family-owned businesses struggling with succession and searching for buyers is still increasing. However, the UK's EU Referendum, whereby a majority of the British population voted to leave the European Union, marks the start of a period of uncertainty in the global markets and in M&A activity. Although the exact influence of Brexit on the M&A market remains unclear, Belgian economic activity in general is expected to be negatively affected.

No legislative initiatives that would have an impact on the market are currently foreseen, and no new initiatives that would negatively affect the activity of leveraged and acquisition financings are expected from the current government.

18 Cass. Civ. 1st, 26 September 2012.

19 Article 2, first paragraph, 1° of the Royal Decree of 27 April 2007 on public takeover bids.

20 Article 2, first paragraph, 3° of the Royal Decree of 27 April 2007 on public takeover bids.

21 Article 5 of the Law of 1 April 2007 on public takeover bids.

Chapter 5

BRAZIL

Fernando R de Almeida Prado and Fernando M Del Nero Gomes[1]

I OVERVIEW

The Brazilian mergers and acquisitions (M&A) market has gained momentum during the past few years following a period of economic stabilisation and growth that led the country to investment-grade status, consolidating Brazil's place among the largest and most important global investment destinations. However, the investment community has been concerned about Brazil's ability to sustain this status given a serious political and economic crisis that has engulfed the country during the past couple of years, which peaked with the impeachment of president Rousseff; 2015 ended with historically ruinous economic indicators.[2] For M&A practitioners who insist on seeing the bright side of things, some side effects of the crisis (the

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2 Brazil entered a technical recession in Q2 and finished the year with a 3.8 per cent per cent negative GDP. Forecasts for 2016 continue to point to another negative growth year (around 3.5 per cent per cent), but the forecasts have been improving since May and current projections show a return to growth in 2017. Inflation expectations follow the same optimistic trend, but are also influenced by the recession: consumer index (IPCA) is forecast to 7.3 per cent in 2016, declining to 5.5 per cent in 2017 (source: Focus Bulletin issued by the Central Bank of Brazil, 24 June 2016: www.bcb.gov.br/pec/GCI/PORT/readout/R20160624.pdf). Given this scenario, all rating agencies have downgraded Brazil's sovereign rating in 2015 (including the loss of investment-grade status by Standard & Poor's) (source: Focus Bulletin issued by the Central Bank of Brazil, 11 September 2015: www.bcb.gov.br/pec/GCI/PORT/readout/R20150911.pdf).

sharp devaluation of the Brazilian currency in 2015[3] and opportunistic distress scenarios, for instance[4]) may help to keep up with the uptick in M&A activity seen in this decade, which hopefully will preserve the country's status as a super-emerging market.[5] The main drivers of M&A activity in Brazil in the past have included increased interest from foreign investors that identify Brazil as a key strategic market;[6] consolidation in certain industries led by local leaders;[7] amplified participation by the government through public pension funds, government-owned entities and banks;[8] and private equity funds taking centre stage in the M&A arena.[9] In recent years, following the global trend, there has been considerable activity in the technology space, with IT leading the M&A rankings in number of deals in

3 In 2015, the Brazilian real lost value against the US dollar, with a 48 per cent increase in the US dollar–real exchange rate. With events on the political scene, this trend reversed sharply from March onwards, and the Brazilian real made significant gains against the US dollar in the first half of 2016 (20 per cent per cent).

4 'The M&A scene in the last couple of years can be described as being a buyer's market. Many sale transactions have been involving distressed assets, large-scale debt restructuring and reorganisation procedures, divestment programmes of private and mixed-capital companies and sudden liquidity concerns.' Marcello Portes da Silveira Lobo in Mergers & acquisitions in Brazil - challenges and opportunities for buyers. *Financier*, July 2016.

5 After peaking in 2014 with 879, the number of announced M&A deals in 2015 returned to the levels of 2011, with 742. The average number of deals for the 2012–2015 period was 792, a 16 per cent increase from the previous period average (2006–2010 (677 deals)) and an impressive 106 per cent increase from the 2002–2005 average of 384. See PWC, Mergers and Acquisitions in Brazil, December 2015: www.pwc.com.br/pt/publicacoes/servicos/assets/fusoes-aquisicoes/fusoes-aquisicoes-dezembro-15.pdf.

6 The participation of foreign investors in M&A deals reached a new high in 2015 with a 51 per cent presence in announced deals,. This includes the largest deal closed in 2015, the 22 billion reais acquisition of GVT (a cable TV operator formerly owned by Vivendi) by Spain's Telefónica.

7 Examples of locally led consolidation include sectors such as telecoms (Oi-Brasil Telecom), education services (the *Anhanguera/Kroton* and the recently negotiated *Kroton/Estácio* mergers were the most prominent among a high number of deals) and retail (*Casas Bahia-Pão de Açúcar, Pão de Açúcar-Ponto Frio, Ricardo Eletro-Insinuante*).

8 Hallmark deals in this category include the acquisition of stakes in distressed financial institutions Banco Panamericano (by Caixa Economica Federal) and Banco Votorantim (by Banco do Brasil) and the government-influenced merger of Sadia and Perdigão to create Brasil Foods (BRF). One of the largest deals announced in 2014 was typical of this category: an 11.6 billion reais joint venture between Cielo and Banco do Brasil to operate debit and credit card processing.

9 The participation of private equity sponsors reached 47 per cent of announced deals in 2013, but in 2014 and 2015 this number retroceded to the -30 per cent per cent level. According to the Brazilian Association of PE and VC, total committed capital by financial sponsors in 2014 broke the 120 billion reais mark in Brazil, representing an impressive 89 per cent growth from 2011. This is on top of an already solid mutual fund and pension fund industry in Brazil, despite the relatively small size of the local capital markets. Important signs of the consolidation of private equity players in Brazil are recent historical fundraising for Brazil by

2014 (259 deals in total).[10] In the aftermath of the massive ongoing corruption scandals and investigations, the M&A community has been intensifying discussions on opportunities arising from major infrastructure players swallowed by the scandals (and how to neutralise associated risks).

From a legal and regulatory viewpoint, several initiatives and reforms have paved the way for a more investor-friendly environment, such as the relatively new bankruptcy law, the arbitration law and the creation of new investment vehicles with favourable structures for investors (e.g., the Brazilian Private Equity Fund (FIP)).

However, historically high interest rates[11] resulted in the M&A activity to develop without the backup of a well-developed acquisition finance market. Banks dominate the lending market, with limited activity in debt capital markets. Only large companies are able to issue debt in the markets at competitive costs, which also results in lack of liquidity and a weak secondary market.

Leveraged buyouts (LBOs) as traditionally structured in the United States or other developed markets are rare. The excessive cost of high-yield debt means that leverage may not be the most efficient form of financing in strategic or private equity deals.[12] However, influenced by the major global private equity firms putting down roots in Brazil, a local LBO market is starting to be evidenced. Moreover, the utilisation of leverage by large strategic buyers in the local market helps to instil LBO-like characteristics in acquisitions, helping to advance the acquisition finance market in Brazil.

In 2012 and early 2013, as the Brazilian monetary authorities aggressively reduced interest rates, market players unveiled ambitious plans to consolidate a robust acquisition finance market in Brazil. Unfortunately, since April 2013, the monetary authorities have reversed this trend, and the policy rate jumped staggering seven percentage points (from 7.25 to 14.25 per cent per annum) on the heels of increased inflationary expectations (which continue to date). The optimism regarding increased leveraged finance deal flows returned to the usual gloom concerning the cost of debt and the difficulties of using the full potential of leveraged acquisitions. But with the political horizon resolving itself and the new government – clearly more aligned with a pro-market agenda – gaining momentum, the dust seems to be starting

major players in the PE space, such as Advent's US$2.1 billion and Patria's US$1.75 billion fundraising in 2014. In 2016, sponsors were back to successful fundraising rounds: HIG announced in April a round of US$740 million focused on middle market acquisitions.

10 This includes active VC players, such as Rocket International and Redpoint Ventures, as well as consolidation in the online space (mergers of olx.com and bomnegocio.com and Ifood and restaurant web).

11 Currently, the policy interest rate sits at 14.25 per cent.

12 'In Brazil, the use of leverage as a PE investment strategy is still limited. Debt financing in Brazil remains very expensive due to high interest rates […] The typical PE strategy of a leveraged buyout (LBO) is not a commonly implemented strategy in Brazil as in more matured economies.' Ricardo Binnie, 'Private Equity Market in Brazil: Key Legal Issues in Fund Formation', *The Journal of Private Equity*, autumn 2013. 'The reason that private equity firms in Brazil do not use debt is simple. In Brazil, money does not come cheap […].' Andrew Ross Sorkin, 'In Brazil, No Room for Leverage at Buyout Firms', *New York Times*, 28 March 2011.

to settle. This will not happen in the short term, however, as the need for macro and fiscal adjustments will dominate the agenda for the next year or so while the country attempts to move away from paralysis in the economy.

Against this unstable macro backdrop, with the noteworthy creativity and resilience of financial professionals and advisers, used to going about their business in unfriendly skies, the market has witnessed the structuring of a decent number of leveraged finance deals. The common features among these Brazilian-version LBOs are as follows.

i Structuring

Leveraged deals are mostly structured by the incorporation of an acquisition vehicle that takes on debt, followed by its reverse merger into the acquisition target. Under Brazilian succession rules, this structure has the same effects of leverage directly taken by or contributed to the target (i.e., the target is responsible for the debt service). In addition, deals usually are structured with fewer tranches when compared with offshore facilities (the traditional structure with revolver, senior, mezzanine junior and subordinated debt, etc., is not usual in Brazil).

ii Borrowers

Although sponsors are becoming more common in the Brazilian M&A arena,[13] most acquisition finance deals are struck by large strategic buyers that are able to leverage their relationship with local banks and obtain cheaper financing costs. This evidences that the local culture in acquisition finance is to provide credit to the buyer rather than to the target, with credit decisions made more based on the soundness of the buyer and less on the ability of target to generate free cash flows.

iii Lenders

Financing is primarily provided by local banks. Syndicated deals and bond (debentures) underwriting structures are less common, and banks tend to commit and hold these loans in their books. The lack of a well-developed secondary market affects the ability of banks to use 'best-efforts' structures and spread the risk with institutional investors. This increases costs and limits credit supply in the market. Coupled with the high costs to hedge foreign exchange exposure and the high concentration of the Brazilian financial system in the hands of local players,[14] this scenario substantially hurts the competitiveness of foreign players

13 Noteworthy sponsor-backed deals with LBO-like features include GP Investments' acquisitions of San Antonio, Magnesita and Fogo de Chão, Carlyle's acquisitions of Qualicorp and Tok&Stok, Apax's acquisition of Tivit, Vinci Partner's acquisition of PDG and Bain Capital's acquisition of Intermédica. See 'Fundos Turbinam Ganhos com uso de dívida em aquisições'; *Valor Econômico*, 10 October 2012.

14 Taking BNDES out of the equation, the four largest banks in Brazil concentrate nearly 80 per cent of total assets in the system, and all of them are local: Banco do Brasil, Caixa, Itaú Unibanco and Bradesco. Santander, the fifth in the list, is the only foreign player with a national presence. Bradesco is concluding the acquisition of HSBC's operations in Brazil (the sixth in the list), further contributing to this situation. Also, Citi (a top 10 retail bank with historical presence in Brazil) is selling its local operations, most likely to one of the top four banks, according to preliminary reports.

in acquisition finance. Lower interest rates are available through subsidised loans granted by government-owned banks, notably the National Development Bank (BNDES). The prominence of BNDES has increased significantly[15] as it has provided financial support to several important M&A transactions[16] in the Brazilian market at interest rates substantially below the policy rate.[17]

iv Leverage levels

As expected in view of high financing costs, leverage levels tend to be lower when compared with those of US deals. While it is not unusual to use a debt-to-finance ratio of 60 to 80 per cent of the purchase price in a US LBO, in Brazil this ratio rarely reaches the 50 per cent

15 The participation of BNDES in the total credit available in the Brazilian market reached 23 per cent in December 2014, but it is more illuminating to analyse BNDES' total assets evolution in the past 10 years: in 2003, assets totalled 164 billion reais, while in 2015 this reached 931 billion reais (compound annual growth rate of 16 per cent in the period): www.bndes.gov.br/SiteBNDES/export/sites/default/bndes_pt/Galerias/Arquivos/empresa/download/Inf_Contabil_Externo_1215_BNDES.pdf. It is important to note that BNDES financing follows strict regulations and guidelines and can be obtained for specific sectors falling under pre-approved special credit lines (see the Central Bank's study on interest rates and spread at at www4.bcb.gov.br/pec/gci/port/focus/FAQ%201-Juros%20e%20Spread%20Banc%C3%A1rio.pdf). The centre-stage role taken by BNDES in acquisition finance is part of a broader story. The market has been closely watching the Brazilian public sector banks grow their loan books exponentially while private players took a more cautious approach (to take more recent numbers, while private banks credit portfolio rose 5.4 per cent from April 2014–April 2015, public sector banks rose its portfolio by 15.5 per cent). By March 2015, the public banks' outstanding credit rose to 54 per cent of the total (Caixa Econômica Federal, Banco do Brasil and BNDES – all three government-controlled – being the top three banks in total credit in Brazil. Over the past few years, economists and multilateral bodies (including the International Monetary Fund (IMF)) have voiced their concerns about this situation. Besides an increased participation of the public sector in the economy, experts feared that a credit bubble was being sponsored by the government, creating difficulties for public banks to maintain healthy capital ratios (mainly in the face of Basel III) and delinquency levels. Several specialised publications have been covering this trend; for example, see 'Brazil: Warning over public-sector bank lending', *The Economist*: www.eiu.com/industry/article/1351100719/brazil-warning-over-public-sector-bank-lending/2013-10-23.

16 Among those deals backed by BNDES financing, we highlight the mergers that created Brasil Foods (BRF) and Fibria.

17 The average interest rates charged by financial institutions help to understand this scenario: for the entire market, average interest rates are 27.6 per cent per annum. For corporates, the average rate is 19.2 per cent per annum. In the category of directed credit (i.e., pre-approved lines, which comprise rural, real estate and all BNDES loans), this rate falls to 9.2 per cent per annum. See the Central Bank's monetary policy and interest rates note at www.bcb.gov.br/?ECOIMPOM.

mark.[18] To put things in perspective, while in developed markets financial leverage drives on average 33 per cent of private equity returns, in Brazil this number is only 3 per cent, leaving all upside to operational improvements and growth.

These characteristics point to the uniqueness of the Brazilian acquisition finance market. Market players overcome one of the highest financing costs in the world, putting together important acquisition finance structures and local versions of LBOs. In addition, legal and regulatory aspects affecting the acquisition finance in Brazil are far from straightforward, featuring a highly regulated financial market and complex tax system.

II REGULATORY AND TAX MATTERS

i Regulatory overview

When dealing with the regulatory aspects of acquisition finance and debt structuring in Brazil, the most important regulatory bodies are the Central Bank of Brazil (Central Bank) and the local Securities and Exchange Commission (CVM). Both entities are under the supervision of the National Monetary Council (CMN), the body ultimately responsible for the Brazilian financial system.

Broadly speaking, financial institutions are regulated by the Central Bank. Only those institutions authorised by the Central Bank are legally allowed to originate and provide credit on a regular basis as their main activity.[19] The risk for institutional investors or other entities that engage in the provision of loans or credit origination is to be deemed financial institutions without proper authorisation, which can lead to severe sanctions, including in the criminal sphere.

Under the above scenario, a non-financial investor may invest in credit instruments but should be careful not to engage in credit origination and lending with proprietary capital as its principal activity.[20] Although traditional capital markets financing and secondary markets remain timid in Brazil (owing to the combination of high interest rates and the prominence of large banks and government banks as the main agents of credit), a number of alternative credit markets have developed to fill the void.

Among these alternative funding structures, the development of securitisation is noteworthy. Securitisation structures cover a wide spectrum of receivables, ranging from personal banking loans to complex infrastructure projects, fostering the development of a

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18 'The lack of a developed market for private debt continues to be a barrier for big leverage buy-outs. Ninety per cent of funds surveyed said that on average deals are done with 25 per cent debt or less' (www.pwc.com.br/pt_BR/br/publicacoes/setores-atividade/assets/private-equity/insead-brazilian-private-equity-2014.pdf). The high financing costs offer less margin to manoeuvre for Brazilian companies that are targets of LBOs. If operating problems occur in the months following an acquisition, while leverage levels are still high, refinancing costs are prohibitive. There are a few precedents of tumultuous refinancing of leveraged companies while still held by the acquiring sponsors in Brazil.

19 The definition of financial institution is provided by Article 17 of Law 4595/64. The relatively wide rule causes uncertainties to the extent its application depends on interpretation by regulators and courts.

20 Note that this concern does not apply to foreign entities that offer credit to Brazilian entities.

credit secondary market. Two important regulatory milestones in the early 2000s helped foster this market: the creation of financial securitisation companies[21] and the emergence of receivable funds (FIDCs), regulated both by the Central Bank and the CVM.[22]

While financial securitisation companies never gained much traction, FIDCs became a popular, widely used alternative structure to the traditional funding sources in Brazil.[23] Factors such as favourable tax treatment and structuring flexibility attracted several local and foreign investors, leading FIDCs to post double-digit yearly growth in assets. Currently, in excess of 50 billion reais are under management by FIDCs, and industry experts forecast that this could reach over 180 billion reais in the next 10 years. However, the utilisation of FIDCs and securitisation structures has been less common in leveraged finance structures.

More recently, important regulatory changes and the creativity of financial sponsors and their local advisers are playing an important role in helping jumpstart a new wave of LBOs.

Most private equity deals in Brazil are structured through the previously mentioned special type of investment fund, the above-mentioned FIP. FIPs emerged in 2003 in an attempt by regulators to provide financial sponsors with a sophisticated and flexible structure to conduct investments in Brazil that offered clear advantages compared with the traditional corporate structures.[24] Several features, including tax incentives, contributed to the success of FIPs and ultimately to the reshaping of local M&A deal structuring.[25]

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21 CMN Resolution 2686 of 27 January 2000.

22 CMN Resolution 2836 of 31 May 2001.

23 'Recently, the Central Bank has created investment funds based on credit rights, the "Receivables Funds", which have been further regulated by CVM. Such Receivables Funds may acquire most kinds of credits, including bank credits. Since this new mechanism is more flexible and tax efficient than the use of a Financial Credit Securitization Company vehicle, it has been increasingly used for the securitization of bank assets.' Antonio Mendes and Bruno Balduccini, Brazil chapter in *Regulation of Foreign Banks*; 5th edition (2008); LexisNexis; edited by Ralph Reisner and Michael Gruson.

24 'The most popular private equity vehicle in the Brazilian M&A practice is by far the FIP, whose structure bears some similarity to the partnership fund model generally adopted in the US and in Europe […] CVM introduced FIPs to Brazil through Rule No. 391 (CVM Rule 391/03), issued on 16 July 2003. By laying down the legal and regulatory grounds for the establishment of an investment conduit that local and foreign investors formerly lacked when sponsoring private equity ventures in Brazil, CVM Rule 391/03 largely contributed to a rapid expansion of FIPs in M&A deals. More importantly, investments and exit strategies successfully implemented by FIPs since 2004 created an encouraging track record that helped Brazilian private equity-backed M&A transactions achieve high priority on the agendas of institutional investors.' José Carlos Meirelles and Caio Ferreira Silva, 'Brazilian Private Equity Funds FIPs: A DNA Change in Brazilian M&A Deals'; *Harvard Business and Law Review* online, Volume 4, 2013.

25 'The regulatory flexibility and generally favourable tax regime accorded to FIPs make FIPs a unique and powerful tool for structuring M&A transactions involving targets in Brazil. Additionally, investors can utilise FIPs for fundraising, deal financing and implementing exit strategies, as applicable CVM regulations allow the placement of their units in the market.' (Meirelles and Silva, ibid.)

Although FIPs are not allowed to take on debt, they have recently been authorised to provide guarantees and collateral to the benefit of their holdings. This holdco-level backstop allows financial institutions to provide cheaper financing to SPVs and targets of private equity investments, allowing more transactions to be structured as Brazilian-version LBOs in the local market. The success of these guarantee structures, yet to be tested in terms of structural and financial feasibility, has the potential to start a new chapter in the development of acquisition finance and sponsor-backed M&A in Brazil.

ii New regulatory topics

Among new regulatory topics affecting debt financing in Brazil, two in particular have attracted attention and called for specific measures by local agents.

Anti-Corruption Law, compliance due diligence and protection for buyers

A new Anti-Corruption Law became effective on 29 January 2014. Although not aimed specifically at financial institutions or institutional investors, its close ties with anti-money laundering provisions make it a hot topic for lenders. The new law brought about heightened anti-corruption standards, including the introduction of concepts from the Foreign Corrupt Practices Act and the mandatory introduction of anti-corruption policies and compliance training within companies.[26] Financial institutions already subject to anti-money laundering will have to adapt current structures to comply with the provisions of the new Anti-Corruption Law, and this trend can be seen in acquisition finance structures already (banks are requiring targets to represent compliance with anti-corruption law).

Significant issues arising from the implementation of the Anti-Corruption Law soon became apparent in the context of the successive corruption scandals that emerged in Brazil. These include:

a the emergence of multiple opportunities to acquire assets and companies that were fundamentally successful but implicated in corruption scandals;

b the need for buyers and finance providers to measure and protect against the risk arising from compliance and corruption-related actions in the target companies;

c heightened due diligence standards;

d contractual implications, mainly related to buyer projections, termination events and MAC; and

e the need for specific legislative regimes to ensure limitation of liability for buyers of toxic assets, to preserve economic activity.

26 'It will certainly cause corporations to undergo significant changes in the way they conduct their operations in Brazil, to the extent that training of employees and adoption of compliance programmes will become mandatory corporate governance measures. While multinational companies and national companies with operations abroad or with stocks or securities on foreign stock exchanges have already adhered, to a lesser or greater extent, to compliance programs, other companies must get prepared to be brought in line with the provisions of the Bill'. Marcos Restrepo, 'The Anti-Corruption Bill', *Biblioteca Informa Newsletter*, Pinheiro Neto Advogados, 13 July 2013.

The fact that several of the players involved in corruption scandals ended up in court protection regimes[27] may relieve some of the concerns resulting from specific protections afforded to purchasers by the Brazilian Bankruptcy Law,[28] but there are still uncertainties related to certain succession risks (such as corruption losses) that will require adaptation from agents in the market and will create a new baseline for what is 'market' in deal documents.[29]

Social-environmental risk management

Until 2012, the observance by local financial institutions of social and environmental standards in lending and financing activities was voluntary. Some major players had set up independent structures to comply with international accords such as the Equator Principles.[30] In April 2014, the CMN extended the social-environmental responsibilities to all entities operating under the Central Bank's authorisation[31] by introducing the social environmental risk policy (PRSA). It should be noted that financial institutions must observe this policy not only for their own activities, but also when providing financing to entities.[32] As financial institutions are rushing to adapt their structures to comply with

27 Notably, OAS, a major contractor involved in bribery scandals, sought court protection under the Brazilian Bankruptcy Law.

28 Law 11101 of 9 February 2005.

29 'Sale and purchase transactions in the context of debt restructuring may offer certain protections against customary succession risks, provided that the applicable requirements are met. On the other hand, indemnities for other matters may not be on the table for a variety of reasons, including the multiplicity of stakeholders. Such transactions may require negotiation with, and acceptance of the deal by, the seller, its creditors, courts and the judicial administrator, just to name a few. Depending on the relevant industry, the regulatory agency or granting authority may also play an important role as changes of control are usually subject to approval and compliance with financial, technical and legal qualifications by the buyer. [...]

So, what is left in terms of protections for the buyer? The due diligence should be even more thorough and detailed than usual, with a special focus on compliance matters, not only with respect to the target company, but also the seller, its corporate group and other companies involved in the business. Security or collateral arrangements should also play an important role, considering the difficulty and cost associated with obtaining bank guarantees or M&A insurance in the current market.' Marcello Portes da Silveira Lobo in 'Mergers and acquisitions in Brazil – challenges and opportunities for buyers', *Financier*, July 2016.

30 The Equator Principles were strictly observed by some financial institutions that participated in controversial project finance structures for the construction of mega hydro-power plants in the Amazon region (Jirau, Santo Antonio and Belo Monte plants).

31 CMN Resolution 4327 of 25 April 2014.

32 'In order to comply with the Resolution, the institutions shall maintain an adequate governance structure for implementation, monitoring and effectiveness of the PRSA, including by means of the – optional – creation of a social and environmental responsibility committee to this end. The institutions shall establish an action plan for implementation of the PRSA, which plan, together with the PRSA policy, shall be approved by the Executive Board [...] and, if any, by the Board of Directors [...] of such institutions. Each institution shall appoint an officer responsible for compliance with the PRSA, and provide

the PRSA, it is unclear to what extent the enforcement of the new policies will take place and how strict the supervising authorities will be. The new rules mandate the creation of policies, tools and controls, but do not extend liability to the financial institutions for damages caused by their clients. The PRSA should certainly be on the radar of market players structuring LBOs in Brazil.

In addition to these topics, the antitrust law reform of 2011 affected the M&A market and, consequently, acquisition finance structures: from June 2012, Brazil became a 'pre-merger system', under which merger reviews by antitrust authorities are conducted pre-closing, unlike the previous post-factum reviews. Broad gun-jumping provisions may also cause uncertainties to parties in M&A situations. Waiting periods and conditions precedent-related to antitrust approvals should always be kept in mind by lenders while negotiating leveraged acquisition structures.[33]

iii Tax aspects

As a general rule, the interest expenses incurred under financing transactions, although generally deductible at the level of borrower, are taxable in the hands of the creditor. If interest is paid out to Brazilian legal entities, Brazilian ordinary corporate taxation is applicable. On the other hand, if interest is paid out to non-residents, Brazilian withholding tax (WHT) is due at a general rate of 15 per cent (a 25 per cent rate is applicable if the beneficiary of the income is located in a tax-haven jurisdiction). The WHT rate applicable to interest paid by a Brazilian party to non-residents could be reduced if a double taxation convention (DTC) signed between Brazil and the country in which the beneficiary of the interests is located exists (e.g., under the Brazil–Japan DTC, the WHT rate applicable to remittance of interests from Brazil could be reduced to 12.5 per cent).

In the acquisition finance space, the hot tax topic is the discussion of interest expense deductibility in LBO transactions. In deals with LBO features,[34] tax authorities have frequently questioned the ability of the target to deduct interest expenses for tax purposes. The main argument used by tax authorities relates to the fact that excessive indebtedness was not necessary for the day-to-day operations of targets. We are aware of a few precedents in

for the internal and external disclosure of such policy'. Werner Grau, Maria Christina Gueorguiev and Rosine Kadamani, *Biblioteca Informa Newsletter*, Pinheiro Neto Advogados, 24 June 2014.

33 'On 29 May 2012, the new Brazilian Competition Act (Law No. 12529, enacted on 30 November 2011) (Act) became effective, replacing the former law enacted in 1994. The new Act will change the Brazilian competition system significantly and will have a direct impact on the merger control notifications. In general terms, doing business in Brazil will be affected as the Act now imposes mandatory waiting periods for the implementation of transactions. "Gun jumping" issues will also be taken into account to consider potential fines and negative consequences.' Leonardo Rocha e Silva and Alexandre Buaiz Neto, 'New Rules on Merger Notifications in Brazil', LexisNexis *Emerging Issues* 6727, 2012.

34 As seen above, the main structure utilised in these deals with LBO-like transactions in Brazil is the set-up of an acquisition vehicle that obtains leverage in the market (almost exclusively via bank loans), following a reverse merger whereby the target is the surviving entity, bringing the leverage effects to its balance sheet.

which tax authorities have issued notices of tax assessments to LBO targets that allegedly used excessive leverage to pay less tax (these cases are under discussion with the tax authorities). However, we can say that this type of challenging of tax authorities has become more common in the past couple of years.

Tax law experts have taken a critical stance on the positioning of the tax authorities,[35] which can be credited to the tax authorities' lack of understanding of the LBO structure and its benefits in advancing corporate development. Among their arguments to challenge these views, experts include:

a the business and financial reasoning behind LBOs;
b from the legal and financial standpoints, the success of the structure in several jurisdictions;
c the fact that tax statutes foresee specific situations whereby holding company structures are used for acquisition and tax deductibility arising therefrom;[36] and
d a presumption in the tax laws that interest expenses are generally deductible.

In addition, although Brazilian tax legislation does not expressly regulate LBO transactions, one could substantiate the deductibility for tax purposes of the interest expenses assumed by the target based on the arguments that the debt obligation was originally incurred by the buyer in the regular course of its business, therefore leading to tax-deductible interest expenses; and the acquisition of the target by the buyer is expected to improve the business operations and generation of income of the target, therefore adding to the argument that the allocation of interest expenses to the target should not be viewed as unusual and unnecessary to the execution of its business.

Fortunately, so far the Tax Payers Council (the administrative body responsible for the analysis of tax infractions notices issued by tax authorities in Brazil) has adopted a favourable position when dealing the matter. Recently, the Tax Payers Council issued a decision recognising the deductibility of the interest expenses incurred upon an LBO transaction, stating that loans taken to finance acquisitions of equity interest should be considered as a common and regular operation. In addition to this good precedent, a recent reform on mergers and consolidation rules for public companies enhanced the list of arguments to defend this position. In the past, the reverse merger of a leveraged financing vehicle into a listed company was considered abuse of control power and this was used as an argument by tax authorities, but this restriction was lifted in the new rule.[37]

Note that objective limitations to interest expense deductibility in LBO structures include:

a leverage being connected to an acquisition performed at market conditions;
b all records and documentation relating to the interest expense being present;
c actual utilisation of the funds to perform the acquisition; and

35 See Giancarlo Matarazzo and Rubens Biselli's article on the matter in *Revista Dialética de Direito Tributário* No. 228.

36 Law 11727 of 23 June 2008.

37 CVM Instruction No. 565 of 15 June 2015, which amended and revoked provisions of CVM Instruction No. 319 of 3 December 1999, dealing with the topic of mergers and consolidations of public companies.

d observance of the transfer-pricing[38] and thin-capitalisation rules in cases where the beneficiary is considered a related party or is domiciled in a tax haven jurisdiction.

Thin capitalisation rules in Brazil are relatively recent and were introduced by Law 12249 of 11 June 2010. Under the rules, thin capitalisation occurs whenever the capital of a company is irrelevant when compared with the liabilities maintained in face of equity holders. The scope of Brazilian thin capitalisation rules comprises debt granted by equity holders, debt granted by other affiliates and debt granted by any entity domiciled in a tax-haven jurisdiction, regardless of corporate affiliation.

III SECURITY AND GUARANTEES

i Fiduciary sale

When structuring debt deals and acquisition finance guarantee packages, the main goal of lenders is to ensure quick access to assets, preferably without bankruptcy and insolvency risk. In this scenario, the fiduciary sale or assignment in guarantee[39] has become the most common type of guarantee in the financial markets. Law 10931 of 2 August 2004, which amended Law 4728 of 14 July 1965, extended the application of the fiduciary sale to transactions executed within the financial and capital markets, which prompted an exponential increase in the use of this collateral structure.[40]

Among the characteristics of the fiduciary sale, two are of great importance for the widespread utilisation of this specific type of guarantee: the relative ease of foreclosure in an event of default (including the possibility for the creditor to perform an extrajudicial sale of the assets given in collateral), and the fact that assets given in the fiduciary sale would have special priorities and enhancements in insolvency and reorganisation proceedings involving the debtor.[41]

38 Law 9430 of 27 December 1996 imposes a limited interest rate up to which tax deductibility can occur with respect to loans granted by affiliated entities.

39 In general terms, a fiduciary sale is a tile retention mechanism whereby the fiduciary property of the asset is transferred to the creditor as collateral. In the event of a default, the fiduciary property consolidates to the benefit of the creditor. If all secured obligations are complied with, the creditor has the duty to transfer the title of the asset back to the debtor.

40 A fiduciary sale within the financial markets differs from the traditional fiduciary sale set forth by the Brazilian Civil Code to the extent that the latter refers to liens on non-fungible assets, while the former encompasses liens on fungible assets and credits. A real estate fiduciary sale is dealt with in a different law, and has specific features.

41 Compared with other types of collateral, such as pledges, mortgages and other *in rem* guarantees, this is an important advantage. In this sense, while claims secured by pledges, mortgages and other similar structures have certain priorities in liquidation regimes, beneficiaries of fiduciary sales may foreclose on or request the restitution of the assets granted as collateral and sell these assets outside of the liquidation proceeding. Similarly, in a judicial reorganisation proceeding (similar to a Chapter 11 proceeding), holders of claims secured by fiduciary sales are not subject to the effects of the reorganisation (e.g., not subject to the terms of the reorganisation plan) and may foreclose on the collateral at any time (apart from when

Creditors should be aware that proper formalisation of guarantees such as fiduciary sales is of utmost importance in Brazil to ensure the priorities and enhancements set forth in law. In this regard, fiduciary sales are perfected in writing, by means of a public or private document filed at the relevant office of the Registry of Deeds and Documents located in the debtor's domicile.[42] However, creditors tend to take a conservative stance and proceed with the registration in both creditor's and debtor's place of business (in case of different headquarters or multiple establishments). This additional measure is to ensure enforceability against third parties, but will not affect the validity or effectiveness of the guarantee if not conducted.

There has been some controversy regarding the legitimacy of foreign financial institutions being the beneficiaries of fiduciary sale guarantees under the terms of Law 10931. The prevailing understanding is that foreign financial institutions can indeed be beneficiaries of such guarantees on the grounds that Brazilian law cannot differentiate between foreign and local financial institutions in similar structures. If transactions with equal structure carried out by Brazilian financial institutions are deemed 'within the scope of financial and capital markets', the same treatment should be afforded to transactions carried out by foreign financial institutions facing Brazilian companies. This understanding has not yet been confirmed by the courts.[43]

ii Potential risks in an insolvency scenario

Brazilian law does not have specific provisions characterising LBOs in the context of insolvency procedures and the extent to which indebtedness assumed in an LBO could be challenged.

Lenders structuring credit facilities and guarantee packages should be aware that there is a theoretical risk that the indebtedness assumed or guarantees granted by the target company are challenged by creditors existing at the time the LBO is implemented based on the general protection rules (e.g., rules concerning fraud against creditors) set forth in the Civil Code) or on specific provisions set forth in the Brazilian Bankruptcy Law. A creditor may argue, for example, that the target company did not receive direct consideration or benefit as a consequence of the LBO, and that, as a result of the indebtedness, the target company became insolvent. We are not aware of any lawsuit that has been filed based on such a fact pattern (LBO), and believe that the economic reasoning and business benefits that may arise from an LBO are good arguments against such claims.

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the collateral is essential to the debtor's business – in this circumstance, the foreclosure would be stayed during the 180-day stay period). Courts have generally observed and consolidated this priority of the fiduciary sale.

42 Article 1361 of the Civil Code. Note that, depending on the underlying asset subject to the fiduciary sale or guarantee, additional procedures need to be undertaken, such as in the case of shares (registration of the fiduciary sale with the bookkeeping agent) or real estate (proper registration of the line with the competent real estate registry).

43 With regards to a fiduciary sale of real estate, there has been controversy on the legitimacy of foreign entities as beneficiaries of the fiduciary sale. In view of this, structuring guarantees as traditional mortgages is the safer path to avoid questioning by debtors and local authorities.

IV PRIORITY OF CLAIMS

In the event of liquidation,[44] the Brazilian Bankruptcy Law sets forth a ranking of claims to be paid in a waterfall model with the proceeds obtained from the sale of the debtor's assets. This ranking also applies to extra-judicial liquidation proceedings of financial institutions.

After payment of super priority claims and expenses (including labour-related claims of a salary nature maturing in the three months preceding the liquidation adjudication;[45] expenses essential for the management of the bankruptcy estate; the realisation or payment of claims for restitution (e.g., creditors holding claims secured by a fiduciary sale have the right to repossess their collateral to sell it outside of the liquidation proceeding); payment of the post-petition claims (including debtor-in-possession financings and the trustee's fees[46]), the balance of the proceeds received as a result of the liquidation of assets must be used to pay the pre-petition claims, in accordance with the following order:

a labour-related claims, limited to 150 minimum wages per creditor (amounts exceeding this cap are reclassified as unsecured claims), and occupational accident claims;

b secured claims (secured by *in rem* guarantees such as mortgage and pledge) up to the value of the collateral;

c tax claims, except for tax fines;

d special privilege claims (defined in civil and commercial laws);

e general privilege claims (defined in civil and commercial laws);

f unsecured claims;

g contractual penalties and monetary penalties for breach of criminal or administrative law, including tax law; and

h subordinated claims.

i Second liens

Certain types of security interest such as pledges and mortgages are subject to multiple liens (first, second, third liens or more). Given their nature, security interests composed of fiduciary property (i.e., fiduciary sale or fiduciary assignment) are not subject to multiple liens. Structural subordination requirements in Brazilian leveraged deals are typically not required (usually subordinated within the target's capital structure).

ii Intercreditor agreements

Intercreditor agreements are common practice in Brazil and there is little controversy about their enforceability and effectiveness. Even in highly complex insolvency situations involving syndicated facilities, courts tend to accept the validity of intercreditor provisions. However, the legal ranking of claims applicable to liquidation proceedings (indicated above) will not be amended to reflect the subordination set forth under intercreditor agreements. In this sense,

44 This ranking of claims is not applicable in the reorganisation regimes set forth in the Brazilian Bankruptcy Law. Under such proceedings, as a general rule, the plan will describe how the creditors subject to the reorganisation regimes will be paid.

45 Limited to five minimum wages per employee.

46 DIP financing is a novelty in the Brazilian legal system (introduced by the Bankruptcy Law in 2005) and does not have the same enhancements of the DIP financing under the US Bankruptcy Code.

if a group of unsecured creditors agree to a structural subordination under an intercreditor agreement, it is likely that under the liquidation proceeding all creditors will be paid in the same proportion in the liquidation proceeding and will have to make the necessary arrangements among themselves (e.g., through an agent) to reflect the subordination agreed upon under the intercreditor agreement.

Other issues concerning intercreditor agreements relate to:

a correct and complete identification of the collateral enforceability mechanism in the intercreditor agreement, including sufficient granting of powers to agents acting on behalf of creditors; and

b the ability (standing to sue) of the collateral agent acting on behalf of a foreign creditor to effect local foreclosure of collateral and remit abroad funds obtained to satisfy the obligations.

With the widespread use of intercreditor agreements, local banks in charge of foreign exchange are becoming familiar with the structure, and the concern regarding (a) has been mitigated.

V JURISDICTION

i Choice of law and jurisdiction

The basic principles of private international law were incorporated into Brazilian law by Decree Law No. 4657 of 4 September 1942 (usually known as the Law of Introduction to the Rules of Brazilian Law). Such law establishes that agreements should be governed by the law of the country in which they were entered, but does not exclude the contractual freedom of the parties to elect the law that will govern the rights and obligations under international agreements. Nevertheless, this principle of accommodation of will by Brazilian law is not without limitations.

In principle, the right of the parties to choose the governing law of agreements depends on the existence of a link between the underlying transaction to be performed and the law selected by the parties to govern their obligations.[47] A general limitation applies to the choice of law: the governing law should not violate Brazilian national sovereignty, public policy and good morals or ethics.

Notwithstanding the foregoing, in practice Brazilian courts tend to apply Brazilian law in disputes that should be governed and judged by foreign law. Therefore, if an agreement is to be enforced directly before the Brazilian courts, ideally it should be governed by Brazilian law because the courts are likely to ignore foreign law.

There are certain matters over which Brazilian courts have exclusive jurisdiction: deciding on actions relating to real property located in Brazil; and examining and deciding on probate proceedings of a deceased person's Brazilian estate, even though the deceased was a foreigner and resided outside the country. In addition, any bankruptcy or judicial proceedings must be filed at the courts where the company is headquartered. Outside of these matters, Brazilian courts should have no exclusive jurisdiction.

47 Nonetheless, if the disputes under the agreement are subject to arbitration in Brazil, the parties can freely choose the governing law and rules.

Nonetheless, the filing of a lawsuit before a foreign court does not preclude the Brazilian courts from judging the same case if the defendant, whatever its nationality, is domiciled in Brazil; the obligation is to be performed in Brazil; or the actions result from a fact that occurred or an act performed in Brazil. Thus, in acquisition finance scenarios with obligations to be performed in Brazil and guarantees set up locally, Brazilian courts will always have concurrent jurisdiction.

Judgments obtained abroad may be enforced in Brazil without re-examination of the merits of the case, provided such judgment is final and unappealable, and previously confirmed by the Superior Court of Justice (STJ) in an *exequatur* process.

Such confirmation or *exequatur* by the STJ generally takes from six to 18 months to be granted and it is available only if:

a the judgment fulfils all formalities required for its enforceability under the laws of the country where the judgment was issued;
b the judgment was issued by a competent court;
c the parties involved were duly summoned before the foreign court;
d the judgment is final and not subject to appeal;
e the judgment was legalised by a Brazilian consulate in the country in which the judgment was issued and is accompanied by a certified translation into Portuguese; and
f the judgment is not manifestly against national sovereignty, public policy and good morals or ethics.

Once the foreign judgment has been confirmed, it may be enforced before the relevant Brazilian lower court (usually the courts of the location of the debtor or defendant). Any payment of a debt stated in foreign currency may only be made in Brazilian currency (by means of applying the exchange rate prevailing on the date of actual payment).

Some of the issues discussed above may, however, be prevented by the inclusion of the choice of arbitration in the transaction agreements. An arbitration clause, providing the arbitration tribunal is seated in Brazil, would allow the parties to freely choose the applicable law, avoid concurrent jurisdiction issues and allow the lender to directly enforce the agreement or arbitration awards before the Brazilian courts without the prior confirmation of the STJ.

ii Pre-enforcement procedures

In Brazil, agreements, decisions and arbitral awards may be judicially enforced if the debtor fails to comply with its obligations. However, this does not mean that our legal system does not allow for an extra-judicial enforcement procedure. Foreclosure of a fiduciary sale, for instance, may be carried out extra-judicially in certain situations (e.g., when the encumbered asset is a real property or when the creditor is in possession of the encumbered asset).

Regardless of whether the enforcement will be implemented judicially or extrajudicially, there are certain pre-enforcement procedures that must be complied with by the creditor. These pre-enforcement procedures should help lenders to prove that the debtor had all the necessary chances to cure a default, regardless of whether such default relates to a breach of financial covenant or failure to repay related debt instalments; supplement the collateral; and prevent any foreclosure of the granted security interest.

These procedures should be also followed if the main agreement is governed by foreign law. For instance, if New York law is the governing law of the loan agreement, any potential default of the debtor shall be evidenced before the laws of New York and in accordance with pre-enforcement procedure precedents.

VI ACQUISITIONS OF PUBLIC COMPANIES

i Going-private transactions in Brazil

Although the Brazilian market has seen a reasonable number of going-private and delisting transactions, there are few, if any, issues in these deals that relate to acquisition finance. The same reason noted above for the limited number of LBOs in Brazil applies to going private transactions: prohibitive interest rates hinder more prolific activity by sponsors and other investors to structure a leveraged going private deal. On top of that, the fact that the number of publicly traded companies with dispersed control in Brazil (true corporations) can be counted on one hand limits the situations of public-to-private transactions dependent on leverage.

In this sense, noteworthy going private transactions in the Brazilian market are usually 'elephant' deals conducted by large strategic players in specific situations.[48] Examples include UnitedHealth's acquisition of Amil, BicBanco's acquisition by China's CCB (the latter two followed by a minority delisting tender offer), the *LAN-TAM* merger and Redecard's take-private deal by Itaú, its controlling shareholder. In 2014, Santander Spain concluded an exchange tender offer to delist Santander Brazil, offering shares of the parent bank in exchange for the subsidiary shares. In the wake of the Santander tender offer, other controlling shareholders followed suit, taking back private companies that listed a minority stock (probably owing to the overall poor performance of the stock market over recent years and increased investor pressure). This happened with a number of companies, including the local unit of Souza Cruz, Banco Daycoval and BHG.

In any event, going-private transactions have to follow specific requirements set forth by CVM Instruction 361, of 5 March 2002, which governs tender offers. Among the several types of tender offers, CVM Instruction 361 defines the 'going private tender offer' or 'delisting tender offer', prescribing a mandatory tender offer at fair price as a condition for the cancelling of the registration of a public company.

One issue that may come up relating to debt financing is the equitable treatment of shareholders in the context of a tender offer. Article 4, II of CVM Instruction 361 requires that minority shareholders are treated equally within an offer, including with respect to information on the company and the offeror. In the event that the offeror is obtaining acquisition finance from a financial institution that is also a minority shareholder or has an affiliate that is a minority shareholder, this should not entail additional advantages to such shareholder-lender when compared with the others (which may be difficult to sustain given that naturally, as a lender, such minority shareholder will have better and more complete

48 Notable exceptions of a going-private transaction conducted by a financial sponsor is the acquisition of Tivit by Apax and the recent acquisition of Abril Educação's control by Tarpon. Also recently, the failed attempt to a sponsor-led take private transaction of BR Properties showcased the difficulties of conducting a large take-private deal in Brazilian capital markets.

information than the other minority shareholders). To minimise risks of questioning, the transaction should be conducted at arm's length and the maximum amount of information made available to the lender should also be available in the tender offer prospectus.

ii Squeeze-outs under Brazilian law

The squeeze-out of minority shareholders was introduced in Law No. 6,404 of 15 December 1976, as amended (Corporation Law) as part of a reform passed in 2001 aimed at improving corporate governance and minority shareholder rights.

Along with the additional protection afforded to minority shareholders, which basically requires a tender offer at fair price and the acceptance (or consent) of more than two-thirds of the minority shareholders registered to participate in a special auction as a condition for the delisting, the new legislation permits a squeeze-out in the event that the tender offer is successful (i.e., the company is delisted) and the controlling shareholder holds more than 95 per cent of the company's share capital after the offer.[49]

One important concern that arises in squeeze-out transactions relates to the inability of the offeror to reach the minimum 95 per cent threshold during the delisting auction. In such a case, some alternatives are available to the offeror: it can obtain the 95 per cent threshold in the three-month period following the auction (the put-right period)[50] or it can privately negotiate with the minority shareholders.

VII OUTLOOK

Having witnessed a second impeachment process in the 30 years since redemocratisation, Brazilian institutions have displayed remarkable resistance. As the political and economic crises were intertwined, closure on the impeachment process may now reset the focus on Brazil regaining the ground lost on the world stage during years of recession. Although bad news in the economy continues to force market agents to operate in a wait-and-see mode, the prospects for accelerated fiscal adjustment and urgent reforms (pension, political and labour, etc.) are fuelling distinct optimism, catalysed by a new economic cabinet filled with faces

49 The CVM's interpretation is that if a significant amount of shareholders accept the tender offer, and the remaining balance accounts for less than 5 per cent of outstanding shares, the value offered on the tender offer is considered to be a fair value and there is no reason for a private company to be obliged to maintain a few shareholders in its ownership structure, also incurring in the corresponding additional expenses.

50 There is some controversy regarding the interpretation of the CVM on the feasibility of meeting the 95 per cent threshold during the put-right period. There are good grounds to sustain that this should be acceptable, including a 2010 CVM decision confirming that a private sale upon exercise of the put option during the put-right period shall be construed as a continuation of the transaction carried out on the stock market in which the price was determined. In this sense, legal scholar Nelson Eizirik understands that the acceptance '[…] even if obtained after the tender offer, legitimates the approval of the redemption of the remaining minority shareholders' shares'. *Temas de direito societário*; Nelson Eizirik; Ed. Renovar; Rio de Janeiro; 2005; p. 379.

familiar to the local financial markets. The unknown variable is how long it will take this economic team to put the country back on the track to growth, and the toll any adjustments may take on an already fragile economy.

These uncertainties continue to specifically affect the acquisition finance market. Brazil experienced a historic fall in its GDP of almost 4 per cent in 2015, with a notable fall in the investment component, which came coupled with a hike in inflation of around 10 per cent. These figures are nothing short of disastrous, and ultimately may explain why the impeachment process had to advance quickly during 2016. While the negative growth affects M&A activity and corporate development, inflationary concerns affect the cost of financing, as the monetary authorities have limited ability to lower interest rates – the new Central Bank governor has already indicated that high interest rates will be maintained for the moment. This macro environment is a significant hurdle to any further escalation of acquisition finance activity. However, with these challenges come opportunities, with a depreciated local currency and distressed assets tending to create favourable conditions for good M&A deals, especially for foreign players. This could arguably alleviate some of the negative effects of the crisis in the M&A market.

A number of market-oriented reforms passed in recent decades consolidated a more investor-friendly and sound regulatory market infrastructure, including in the acquisition finance market, which helped boost foreign investment and diversify the country's investor base, consolidating the Brazilian economy's position in the top 10 in the world. The warnings were manifest, however, that the increased level of government interference in the economy, including through the massive growth of lending in public sector banks and price controls, could snowball into a major crisis – and that is precisely what happened.[51]. Hopes are now high that the new government will be able to restart the economy with a market-friendly tool kit, including privatisation and legislative actions to further open the economy, with less interference.

From the legal and regulatory standpoints, revamped due diligence and contractual terms, along with discussions around the limitation of liability for acquisitions of assets

51 'During the past decade, Brazil has achieved substantial progress in capital market development. The menu of available financial instruments has been expanded, market infrastructure has been reformed and strengthened, and a diversified investor base has been built. This was a high-priority agenda for the authorities, and the reforms were introduced in close cooperation with market participants.

'Nonetheless, challenges remain and the continued development process will need careful management. Despite the country's great potential (e.g., large size of economy, sound fiscal management, and large mutual fund industry), Brazil's capital markets are still facing a number of challenges. These include still prevalent short-term indexation, investors' risk aversion to long-term fixed rate bonds, still low liquidity in the secondary market, and managing the role of BNDES. A shift to a lower yield curve environment should continue to gradually take place. But further progress will require continued policy effort to assure macro stability and financial sector reforms to promote the development of longer-term private finance [...] It will also require close monitoring, to avoid a build-up of risks that could be engendered by the search for yield as the yield curve shifts down.' Joonkyu Park, Brazil's Capital Market: Current Status and Issues for Further Development, IMF Working Paper – September 2012.

from companies involved in corruption scandals are hot topics. Also, the economic crisis is subjecting the relatively young Bankruptcy Law to a forced stress test, with a number of restructuring procedures involving enormous companies.[52] For legal practioners, the increasing stream of M&A opportunities within these procedures will be on the radar, as the market experiences a spike in financial sponsors focused on mandates for 'special situation' opportunities. From a taxation standpoint, a favourable resolution of the ongoing tax controversy on the deductibility of acquisition-induced leverage may provide additional transparency and incentives for leveraged acquisitions in the Brazilian market.

52 Such as the judicial reorganisation of Oi, one of the largest Telecom providers in the country.

Chapter 6

CANADA

Jean E Anderson, David Nadler, Carrie B E Smit, David Wiseman and Brendan O'Neill [1]

I OVERVIEW

Leveraged lending is frequently used by Canadian borrowers to fund a number of activities, including acquisitions, capital expenditures, dividend recapitalisations, refinancings of existing debt and ongoing operations. As noted below, acquisition activity in Canada has been relatively steady, and leveraged loans are an important source of capital for many Canadian acquisitions. Continuing low interest rates, substantial liquidity in the North American market and the easing of credit terms have contributed to the attractiveness of leveraged loans for Canadian borrowers.

i Recent Canadian acquisition activity

The pace of acquisitions in Canada was steady but unremarkable during the period from the start of 2015 until the end of the first quarter in 2016. In 2015, deal volume in the Canadian merger and acquisition market decreased by 9 per cent from 2014 with a total of 2,621 deals announced.[2] These transactions totalled C$275.7 billion, an eight-year high for the Canadian market and a 16 per cent increase from 2014.[3] Deal volume peaked in the third quarter of 2015 (with 672 announced deals), and declined for the final quarter of 2015 and into the first quarter of 2016 (with 641 and 602 announced deals, respectively). Mega-deals (i.e., transactions over C$1 billion) drove the increased pace and value of acquisitions in 2015, with the mid-market segment remaining relatively stable. There were 52 mega-deal transactions

1 Jean E Anderson, David Nadler, Carrie B E Smit, David Wiseman and Brendan O'Neill are partners at Goodmans LLP.

2 Crosbie & Company, M&A Quarterly Canadian M&A Online: www.crosbieco.com/who-we-are/m-a-publications. Figures provided are a compilation from 2015 quarterly reports, including revisions that appear in the Q1 2016 M&A Report. Crosbie and Company sets a minimum deal value of C$5 million for inclusion in its data.

3 Crosbie & Company, *supra* footnote 2.

in 2015 with a total value of C$196.5 billion.[4] This trend continued into the first quarter of 2016, with 16 mega-deals announced carrying an aggregate value of C$82.4 billion.[5] Although the real estate sector was the most active industry by deal volume in three of the four quarters in 2015, industrials was the most active in the second quarter with 95 transactions announced. Real estate gained the position of the industry with the highest deal value in 2015 (representing 21 per cent of a total Canadian deal value of C$275.7 billion), but would have come in second to industrials had the Norfolk Southern and Canadian Pacific Rail deal not fallen through.[6] Overall, 2015 was a strong year for Canadian merger and acquisition activity with total deal value hitting near record levels despite declining deal volume. The market was driven by an increase in mega-deals combined with a record level of foreign acquisitions by Canadian firms, notwithstanding the weak Canadian dollar. This activity has been supported by strong valuations, continued low lending costs and growing confidence in US markets, all of which outweighed the negative impact of slower activity in the mining sector.[7]

ii Canadian financing sources

Canadian companies financed their acquisitions over the past 18 months in a variety of ways. In many cases, a significant portion of the consideration for the acquisition was funded through various types of debt obtained from a variety of sources. Sources include senior secured credit facilities provided by domestic and foreign financial institutions, second-lien credit facilities, unsecured credit facilities, streaming arrangements, high-yield notes and mezzanine debt.

For example, Northern Property REIT financed its acquisition of all of the assets of True North Apartment REIT with a senior secured non-revolving term loan facility provided by two Canadian chartered banks, as well as a senior non-revolving bridge facility. Element Financial financed its acquisition of GE Capital's fleet management business with a combination of convertible debentures and rate reset preferred shares. Concordia Healthcare financed its acquisition of Amerpharm Mercury with a combination of senior revolving and term loans and bridge debt facilities, equity issuances, and a private placement of senior notes. Although these mentioned transactions represent only a fraction of the acquisitions recently done by Canadian companies, they provide good examples of highly leveraged financings for major acquisitions in Canada.

4 Ibid.

5 Crosbie & Company, 'Canadian M&A Q1 2016 Report', online: www.crosbieco.com/ma/index.html.

6 Crosbie & Company, footnote 2, *supra*.

7 Crosbie & Company. Figure 2 illustrates the Canadian domestic M&A activity continued to decline in Q1 2016. There were 408 transactions involving Canadian targets (including both those with domestic or foreign buyers). This is down 5 per cent from 428 transactions in Q1 2015.

II REGULATORY AND TAX MATTERS

i Regulatory matters

Lender-related regulatory requirements

Canadian borrowers regularly obtain acquisition financing and leveraged finance products from a broad range of lenders including domestic and foreign financial institutions, private equity and hedge funds, and through the issuance of public debt, including high-yield debt. Canadian and foreign banks are very active in this area and provide a wide variety of debt products to Canadian borrowers. The key regulatory issue for lenders dealing with Canadian borrowers is whether the lender would be considered a bank for Canadian regulatory purposes. The activities of Canadian banks and foreign lenders affiliated with foreign banks that are carrying on banking business in Canada are subject to regulation under the federal Bank Act (Canada) (Bank Act). Lenders that are banks or affiliated with foreign banks must obtain the necessary approvals under the Bank Act in order to establish a presence in Canada and must comply with the operational requirements of the Bank Act on an ongoing basis.

Foreign lenders affiliated with foreign banks that do not have a presence in Canada may lend to Canadian borrowers without obtaining regulatory approvals from federal banking regulators if the lending relationship is established in a way that would not involve the lender being viewed as carrying on business in Canada. Generally speaking, a loan that is made by a lender located outside of Canada and that is approved, negotiated and documented outside of Canada with payments being made to an entity outside of Canada should satisfy this test.

Absent connection with a bank, foreign and other lenders that are not otherwise regulated as financial institutions in Canada (e.g., insurance companies, trust companies and credit unions) do not require any special licences or regulatory approvals to make a loan to a Canadian borrower. Such lenders will, however, be subject to laws of general application that apply to the taking and enforcement of security in certain provinces. For example, a lender may require an extra-provincial licence under provincial legislation to hold and enforce a mortgage on real estate in that province. Lenders that lend on the security of real property may also need to obtain a mortgage brokerage licence under provincial legislation if they are not a financial institution exempted from compliance.

Borrower-related regulatory requirements

The activities of many Canada borrowers are subject to some degree of government regulation, and often a particular government licence or approval is a key component of the borrower's business operations. Lenders to such borrowers should ensure that the borrower obtains all necessary governmental consents required to grant security on its assets to secure the proposed financing and to permit the lender to realise on its security. In addition, any transfer of a regulated borrower's assets (including any applicable licences) as part of the realisation process may well require further governmental approvals, including approval of the proposed acquirer.

Canadian anti-money laundering legislation

The Proceeds of Crime (Money Laundering) and Terrorist Financing Act (Canada) makes it mandatory for certain entities (including lenders) to undertake measures to ascertain the identity of Canadian borrowers and related parties before accepting them as clients, report a variety of transactions to the Financial Transactions and Reports Analysis Centre of Canada and to maintain certain client and transaction records. These requirements are designed to assist in the detection and deterrence of money laundering and the financing of terrorist activity in Canada and around the world. Lenders should ensure that their due diligence requirements include a request for the information necessary to ensure compliance with this legislation and that their borrowers covenant to provide this information on an ongoing basis.

ii Tax matters

Canadian tax issues must also be considered when structuring acquisition financing.

Withholding tax

Under the Income Tax Act (Canada) (Tax Act), interest paid by a Canadian resident debtor to an arm's-length non-resident creditor will not generally be subject to Canadian withholding tax, provided that the interest is not participating (e.g., contingent or dependent on the use of or production from property in Canada or computed with reference to revenue, profit, cash flow, commodity price or similar criterion, or by reference to dividends paid). Where interest is subject to withholding tax under the provisions of the Tax Act (either because it is paid to a non-arm's-length creditor or is participating), the terms of an applicable bilateral tax treaty may apply to reduce the rate of withholding tax from the Canadian domestic rate of 25 per cent. Under the provisions of the Canada–US Income Tax Treaty, the rate is reduced to 15 per cent if the interest is participating, or otherwise to zero per cent. Most other treaties reduce the rate of withholding tax on interest to 10 per cent.

Interest deductibility

Interest is only deductible to a Canadian resident debtor where it meets certain technical requirements set out in the Tax Act. In particular, interest (not in excess of a reasonable amount) is generally deductible on (1) borrowed money used for the purpose of earning income from a business or property; or (2) an amount payable for property that is acquired for the purpose of gaining or producing income from a business or property. Interest payable on financing incurred to fund the acquisition of an asset to be used in the debtor's business should generally be deductible. Similarly, interest payable on financing incurred to fund the acquisition of shares of a company (where there is a reasonable expectation of income from the shares) should also generally be deductible. Where the Canadian resident debtor incurs debt to finance the acquisition of shares, and it then amalgamates with, or winds up, the target company, the interest payable on that debt will generally continue to be deductible (on the basis that the income producing shares are now replaced with income-producing assets).

Thin capitalisation rules

Under the Tax Act, interest payable by a Canadian resident debtor may not be deductible to the debtor, and also may be subject to Canadian withholding tax on an accrual basis, if the Canadian thin capitalisation rules are applicable. These rules generally apply where (1) the creditor owns (or has a right to acquire) shares of the debtor representing 25 per cent or more of the votes or value of the debtor's capital stock, and (2) the debt-to-equity ratio of the debtor with respect to such non-resident creditors is in excess of 1.5:1. The thin-capitalisation rules may apply in a situation where acquisition financing is undertaken by a non-resident parent corporation which then on-loans the funds to its Canadian subsidiary, which acquires the target assets or shares.

Consolidation issues

Canadian resident corporations do not file consolidated tax returns (unlike in certain other jurisdictions, such as the United States). As a result, interest payable by a Canadian resident corporation is only deductible to that particular corporation and can only offset income earned by that particular corporation. Where the taxable income of the debtor corporation is not sufficient to offset the interest deductions, other transactions may need to be undertaken to efficiently use the interest deductions in the corporate group. In particular, when an acquirer incurs debt to finance the acquisition of a target corporation, additional steps (such as the amalgamation of the acquirer with the target) may need to be undertaken to facilitate the deduction of the interest on the acquisition financing against the target's operating income.

Stamp and documentary taxes

There are no stamp or other documentary taxes in Canada to which loan or securitisation documentation or loan-trading documentation might be subject.

Foreign Account Tax Compliance Act

Under the US Foreign Account Tax Compliance Act (FATCA), payments made to foreign creditors under Canadian financing or leveraged finance arrangements may, in certain circumstances, be subject to a 30 per cent US withholding tax. Where there is a risk of FATCA withholding, the applicable loan or debt financing instrument will typically require the foreign creditor to provide such documentation as may be necessary for the debtor to comply with its obligations under FATCA and to determine whether the creditor has complied with its obligations under FATCA, or to determine the amount of FATCA withholding tax that will be deductible from payments made under the instrument. A Canadian debtor will typically not provide a gross-up to the foreign creditor for amounts deducted on account of FATCA withholding tax.

III SECURITY AND GUARANTEES

Secured loans are often used in Canada to finance acquisitions. The forms of security and guarantees most commonly used in the Canadian market to secure personal and real property assets, as well as the regime for taking security under the Civil Code of Quebec (QCC) and the common law applicable in the other provinces and territories, are discussed below.[8]

8 The common law provinces and territories in Canada are British Columbia, Alberta, Saskatchewan, Manitoba, Ontario, New Brunswick, Nova Scotia, Prince Edward Island, Newfoundland and Labrador, Nunavut, the Yukon Territories and the Northwest Territories.

i Security

Personal property and tangible moveable property

Common law provinces

Each of the common law provinces and territories in Canada has a personal property security statute (collectively, PPSAs) that is modelled on Article 9 of the Uniform Commercial Code in the United States. Under the PPSAs, tangible moveable property consists of goods, chattel paper, documents of title and investment property. In secured financings in the Canadian market, tangible moveable property normally means goods that are equipment or inventory.

Security in this type of property is created when a debtor grants to the creditor a security interest in that property. The granting clause in the security agreement will expressly describe the collateral that the security interest attaches to. Quite often, secured creditors are given a general security interest that secures all of the debtor's existing and after-acquired personal property, both tangible and intangible.

A security interest in tangible property must be perfected if a creditor is to have priority over the interests of other creditors and third parties. Registration of a financing statement in each province or territory where tangible assets are physically located is necessary to perfect a security interest in those assets. The PPSAs are publicly accessible, searchable databases, and a registered financing statement serves as notice that a debtor's assets have been encumbered in favour of a secured creditor. Certain types of tangible personal property such as chattel paper, instruments, money, documents of title and large goods can also be perfected by possession.

Quebec

Security over tangible moveable property in Quebec is created by a hypothec. Registration at the Register of Moveable Real Rights (RMRR) perfects the hypothec. No written agreement is needed where a hypothec is taken with delivery (i.e., a pledge). Perfection occurs when the pledged collateral is physically delivered to the pledgee.

Federal jurisdiction

Security in aircraft, ships and most railways is governed in Canada by federal legislation. While security interests in these types of assets can be taken under the PPSAs or the QCC, secured parties are well advised to consider any applicable federal legislation and to take the additional steps prescribed therein to establish a first-ranking claim on such assets.

Personal property and intangible property

General – common law provinces

Intangible personal property includes claims and receivables, intellectual property (IP) rights and investment property.[9] Generally, creditors secure intangibles similarly to tangibles, by

9 The PPSAs expressly exclude an interest in or claim under any insurance policy or annuity contract from their scope. Secured debtors must take steps outside of the PPSAs to secure an interest in an insurance policy. The PPSAs do, however, provide that a previous security interest in other secured personal property assets extends to the proceeds of insurance on such assets. In Quebec, insurance policies can be charged by a hypothec.

way of a security agreement and perfection by registration under the PPSAs.[10] The law of the jurisdiction where the debtor is located[11] at the time the security interest attaches governs the validity, perfection and priority of a security interest in intangible personal property.

While IP ownership rights are governed by federal legislation in Canada, security in these intangibles is governed by the PPSAs. A security interest is created in IP rights through a grant of security under a security agreement and is perfected by registration. In addition, it is common practice for secured creditors with a security interest in Canadian trademarks, copyright or patents to file a copy or notice of the security agreement with the Canadian Intellectual Property Office.

General – Quebec

Under the QCC, the law of the jurisdiction where the grantor is domiciled (i.e., where its registered office is located) governs the validity and perfection of security over intangibles. Intangibles (incorporeal moveable property) such as claims, receivables, contractual rights and IP rights owned by a debtor domiciled in Quebec are secured under the QCC by way of a hypothec that is perfected by filing in the RMRR.

Investment property

Financial assets such as shares and other securities are considered investment property under the PPSAs. Almost all of the common law provinces and territories have a Securities Transfer Act or similar legislation (STAs) that is based on Revised Article 8 of the Uniform Commercial Code. The STAs work together with the PPSAs to govern the creation and perfection of security interests in investment property. The QCC also contains provisions specific to investment property.

Investment property under the PPSAs and STAs includes securities (uncertificated and certificated), securities entitlements, securities accounts, futures contracts and futures accounts. In secured financings in Canada, the type of investment property seen most commonly is certificated securities. A borrower or guarantor would typically pledge the certificated shares it holds directly in a subsidiary to a lender to secure its obligations owing to that lender.

In addition to execution of a security agreement and filing under the PPSAs to perfect an interest in investment property as an intangible, secured creditors can also establish 'control' or possession over such property. Control is the best method for perfecting such an interest as it gives the secured party a higher priority than a security interest perfected by registration alone.

10 Certain government receivables payable by the federal government of Canada and the provincial and territorial governments cannot be assigned or transferred as security unless secured parties comply with certain conditions prescribed by statute.

11 Generally, under the PPSAs, a debtor is located at its place of business or if a debtor has more than one place of business, where it has its chief executive office. In Ontario, however, new deeming rules for determining a debtor's location under the Personal Property Security Act (Ontario) became effective on 31 December 2015. The new rules determine a debtor's location based on what type of entity the debtor is. For example, provincial corporations are deemed to be located in the province or territory of incorporation or organisation.

Where investment property is held directly by a debtor, a secured party obtains control of certificated securities by taking possession of the certificates and either taking an endorsement or having the securities registered in its name. For uncertificated securities, control is achieved by either registering the securities in the name of the secured party or by obtaining a control agreement from the issuer of the securities. A control agreement is a tripartite agreement among the issuer, the debtor and the secured party and provides that the issuer agrees to comply with instructions from the secured party with respect to the securities without the debtor's further consent.

Where the investment property consists of securities entitlements held indirectly by the debtor through a securities intermediary, the secured party obtains control by arranging for the securities intermediary[12] to record the secured party as the entitlement holder; obtaining a control agreement from the securities intermediary; or having a third party obtain control on its behalf.

Real property

The most common forms of security over real estate in the Canadian market are mortgages, debentures, hypothecs and trust deeds. Real estate in the common law provinces and territories includes land (together with buildings and fixtures), airspace above land, crops, forests, non-navigable waters, easements, sub-surface land rights, rental income, and other profits derived from land and leasehold interests. Real estate under the QCC includes land, any constructions and works of a permanent nature located on the land and anything forming an integral part of the land, plants and minerals that are not separated or extracted from the land, personal property that is permanently physically attached and joined to an immoveable and that ensures its utility and real rights in immoveable property, as well as actions to assert such rights or to obtain possession of immoveables. Each province and territory in Canada has a real property title registration system. Secured creditors perfect interests in real property by filing their mortgage, debenture, hypothec or trust deed against the title to the debtor's real property. There are some special statutes in Canada that govern most federally regulated facilities such as airports, prisons and major shipping ports, and these should be assessed when taking security involving such facilities.

ii Guarantees

Guarantees are a common feature of secured lending structures for acquisition and other types of financings in the Canadian market. Typically, a guarantor (e.g., a parent or corporate affiliate of the borrower) will enter into a stand-alone guarantee with a lender that guarantees the obligations of the borrower to the lender. In the acquisition context it is not uncommon for the obligations of a sole-purpose acquisition entity to be guaranteed by an equity sponsor or controlling parent company. In Quebec, suretyships are used frequently in secured lending.

iii Guarantee limitations

Financial assistance

Corporate legislation in Canada has eliminated outright restrictions on financial assistance. It is permitted without restrictions of any kind in several provinces, including Ontario and

12 For example, a clearing house, retail investment broker or bank.

Nova Scotia. In other provinces and territories, financial assistance is also permitted generally but is subject to a solvency test or disclosure requirements. This more relaxed regime has provided increased flexibility to lenders in Canada when structuring security packages that include guarantees.

Corporate benefit

There is no corporate benefit requirement under Canadian corporate law statutes. However, a financing transaction that does not provide any apparent benefit to a corporation may be challenged as oppressive by creditors or minority shareholders or may result in an allegation that the fiduciary duties of the corporate directors approving the transaction have been breached. Guarantees supporting the debt of affiliated entities are generally enforceable and valid in Canada as long as the debt is of benefit to the corporate group as a whole.

iv Agency concept

Except for Quebec, the concept of agency has long been recognised in all Canadian jurisdictions and is commonly used in secured loan structures in Canada. Agents are often used to represent lenders in a syndicate or to hold collateral on behalf of lenders.

Until very recently, the concept of holding security for others was not recognised under Quebec law. Most lending lawyers in Quebec had taken the view that an agent had to be formally appointed as a person holding the lenders' power of attorney to hold a hypothec without delivery on behalf of future, unknown members of a syndicate of lenders. In the spring of 2015, the Quebec government revised Article 2692 of the QCC to clarify this uncertainty. Under revised Article 2692, a hypothec may be granted to a 'hypothecary representative' for all present and future creditors of the obligations secured by that hypothec. This clarification has been well received in the Canadian market.

v Challenging security under Canadian law

Under Canadian law, there are several ways that a creditor or court-appointed officer could challenge security both before or after the commencement of insolvency or restructuring proceedings. Remedies for 'reviewable transactions' are available under federal insolvency legislation and provincial legislation.

In the context of insolvency proceedings, a trustee in bankruptcy[13] can challenge preferences and other transactions at undervalue under the federal Bankruptcy and Insolvency Act (Canada) (BIA). Under Section 95 of the BIA, a trustee in bankruptcy can challenge a preference (i.e., a transaction with a debtor or payment made by a debtor that has the effect of preferring one creditor over another). If the preference is proven, the transaction or payment is void against the trustee in bankruptcy. Under Section 96 of the BIA, a trustee in bankruptcy can attack transactions between the debtor and persons who provided the debtor with inadequate consideration for assets, goods or services provided by the debtor. Courts can order that transfers at undervalue are void against the trustee in bankruptcy or, alternatively, that the parties to the transfer pay to the debtor's estate the difference between

13 Where a trustee refuses or neglects to take proceedings after being requested to do so by a creditor, then that creditor may make an application to the court for an order authorising it to take the proceedings in question in its own name and at its own expense and risk.

the consideration received by the debtor and the consideration given by the debtor. To the extent that transactions are rendered void as against a trustee in bankruptcy and the property in question has been further transferred, the BIA provides that the proceeds from the transfer of the property shall be deemed to be the property of the trustee. These sections of the BIA also apply (with any modifications that the circumstances require) to corporate restructuring proceedings under Canada's other major insolvency and restructuring statute, the Companies' Creditors Arrangement Act (CCAA).[14]

Provincial legislation is also available to creditors or trustees to attack preferential transactions. While there are differences among the various provincial statutes, most provinces allow a creditor to attack fraudulent conveyances and unjust preferences.[15] In general terms, fraudulent conveyances are transactions where conveyances of real or personal property are made with the intent to defeat, hinder, delay or defraud creditors or others. Unjust preferences are preferential payments or transactions made when the debtor was in insolvent circumstances, unable to pay its debts or knew that it was on the brink of insolvency. Transactions found to be fraudulent conveyances or unjust preferences can be voided as against creditors. Finally, in almost all Canadian provinces and territories, creditors may use the oppression remedy under provincial corporate law to challenge security given by a corporation. This would involve a transaction where the corporation or its directors effected a result or acted in a manner that was oppressive, unfairly prejudicial to or unfairly disregarded the interests of certain parties (including creditors). Where oppressive conduct is found, Canadian courts have broad discretion to grant any remedy they deem appropriate in the circumstances.

IV PRIORITY OF CLAIMS

i Priority claims

In Canada, the priority of the claim of a creditor of an insolvent corporation will depend upon the nature of the claim and the insolvency proceedings applicable to the borrower. The enforcement of security for an acquisition financing may occur in the context of a CCAA or BIA proceeding. An insolvent corporate borrower may reorganise itself under the CCAA or BIA or petition itself into bankruptcy under the BIA. In a Canadian insolvency proceeding, certain claims may be afforded priority over a secured lender in a court order, and the priority of these claims will be determined by the courts based on the facts of each case. In addition, certain statutory charges will continue to have priority over a secured lender's claim in a bankruptcy, including claims for unremitted employee source deductions, certain employee claims that are paid by the Canadian federal government under the Wage Earner Protection Act (Canada), and certain employee and employer pension plan contributions that are due and unpaid. It should also be noted that a number of the Canadian federal and provincial

14 See Section 36.1(1) of the Companies' Creditors Arrangement Act.

15 Court-appointed officers and other parties seeking to challenge a transaction or grant of security may rely on these provincial statutes both within insolvency proceedings under the Bankruptcy and Insolvency Act or Companies' Creditors Arrangement Act and outside of such proceedings.

statutory deemed trust and charges that can prime a lender's security outside of a bankruptcy for unpaid amounts such as holiday pay and sale taxes will be reversed in a bankruptcy for the insolvent borrower.

In a CCAA restructuring, generally speaking, the restructuring plan for the insolvent borrower must provide for the payment of certain employee and other claims unless otherwise agreed by the relevant parties. In addition, the court may grant a charge in priority to the security of existing lenders in the assets of the debtor to secure the claims of critical suppliers, debtor-in-possession lenders, corporate directors' indemnities and professional administration fees.

As noted above, certain pension claims may rank in priority to a lender's security in the event of a borrower's insolvency. The Supreme Court of Canada decision in *Indalex Limited (Re)*,[16] however, has created some doubt as to the priority afforded to the amount of any funding deficiency arising in connection with the wind-up (a 'wind-up deficiency') of a borrower's defined benefit pension plan. Prior to this decision, it was generally thought that the deemed trust provisions of the applicable pension legislation would not apply to a wind-up deficiency. Although the Supreme Court made it clear that a deemed trust could apply to a wind-up deficiency, and that the claim for such amount would be subordinate to a court ordered charge securing a debtor-in-possession financing for the insolvent borrower, the Court did not opine on the relative priority of liens on the accounts receivable and inventory securing indebtedness in existence at the time that a CCAA order is made. Lenders providing financing to a Canadian borrower that has a defined benefit plan registered in Canada or to acquire a target with such a plan should determine whether a deemed trust could apply to a wind-up deficiency under the applicable pension legislation, and consider the impact on their security position in the event of an insolvency.

ii Equitable subordination

Under the US Bankruptcy Code, the doctrine of equitable subordination allows courts to subordinate creditor claims to those of lower-ranking creditors. This extraordinary remedy is typically reserved for situations of egregious conduct on the part of creditors, because it supplants negotiated contractual arrangements between parties. For a claimant to succeed in subordinating a creditor claim, it must demonstrate that the creditor engaged in inequitable conduct, that the conduct harmed other creditors of the bankrupt company or conferred upon the creditor an unfair advantage, and that the subordination is consistent with the remainder of the US Bankruptcy Code.[17]

Although there is no equivalent legislative provision in Canada, recent decisions by Canadian courts have suggested that the doctrine of equitable subordination could be adopted in the right circumstances. In *Indalex*, the Supreme Court of Canada affirmed the 'wait and see' approach it espoused in *Canada Deposit Insurance Corp v. Canadian Commercial Bank*,[18] whereby rather than ruling one way on the doctrine's applicability, it declared that the facts at hand did not give rise to a claim for equitable subordination

16 2013 SCC 6 [*Indalex*].

17 *In re Mobile Steel Co* 563 F.2d 692 (5th Cir 1977) at paragraphs 24–26.

18 [1992] 3 SCR 558 at paragraph 44.

and left its determination for a later date.[19] The Ontario Court of Appeal has, for the most part, followed the same approach.[20] Accordingly, litigants may argue that the doctrine is applicable at the lower court level. However, only in a select few cases has a court applied the US doctrine.[21] Other courts have taken the 'wait and see' approach,[22] and still others have held the doctrine to be inapplicable in Canada.[23] The issue of whether the doctrine of equitable subordination is applicable in Canada will remain unresolved until Canadian courts are faced with egregious creditor conduct of the type that warrants an authoritative decision on the issue.

iii Second-lien financings

As noted above, a Canadian borrower may incorporate several different types of indebtedness (including second-lien loans) in its capital structure. Second-lien loans (also known as term loan B loans) are an increasingly popular source of financing in Canada for acquisitions, recapitalisations and restructurings. Non-bank entities such as hedge funds, private equity funds and distressed debt funds, particularly those based in the United States, are typically the providers of second-lien loans to Canadian borrowers. As second-lien loans are secured by a lien on all or a portion of the borrower's assets, these loans are generally considered to be a lower risk alternative to mezzanine loans and, accordingly, are less costly than mezzanine or other junior unsecured debt. In addition, as a result of investor demand for the enhanced yields available through leveraged products, second-lien loan terms have become more debtor-friendly and a number of borrowers have been able to obtain covenant-lite loans. Often these loans are provided in US dollars, and so are particularly attractive to Canadian borrowers with significant US-dollar cash flows that provide a natural hedge to currency exchange fluctuations that could otherwise affect their ability to make loan payments in US dollars.

The respective rights of the first-lien lenders and the second-lien lenders will be set forth in an intercreditor agreement. A first-lien or second-lien intercreditor agreement will certainly include a contractual subordination of the second-lien lender's lien to the lien of the first-lien lender and restrictions on the ability of the second-lien lender to enforce its lien against the common collateral for the loans. The intercreditor agreement may also include provisions addressing the issues set out below.

iv Intercreditor agreements

Lenders have made a broad variety of debt products available to borrowers to finance their operations, acquisitions and other activities. As a result, many borrowers have complex capital structures with several layers of debt secured by liens on the same collateral. For example, a borrower may have a senior term and operating credit facility, hedging obligations, cash

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19 *Indalex*, footnote 16 at paragraph 77.

20 See, for example, *Re I Waxman & Sons Ltd* (2010) 67 CBR (5th) 1 (OntCA); For an example of the Ontario Court of Appeal subordinating a creditor's claim based on equitable principles, see *Bulut v. Brampton (City)* [2000] OJ No. 1062 at paragraph 77.

21 See, for example, *Lloyd's Non-Marine Underwriters v. JJ Lacey Insurance Ltd*, 2009 NLTD 148.

22 See, for example, *Christian Brothers of Ireland (Re)* [2004] OJ No. 359 at paragraph 104.

23 See, for example, *AEVO Co v. D & A Macleod*, 4 OR (3d) 368 (Ont SC).

management obligations and a second-lien term loan secured by liens on the borrower's assets. Lenders in these circumstances will typically enter into an intercreditor agreement that delineates their respective rights, remedies and priorities particularly in a default situation. Canadian courts will generally treat an intercreditor agreement as an enforceable contract between the lenders and uphold its provisions. However, if the borrower in question is subject to an insolvency proceeding, it is possible that the court supervising the proceeding may make an order that is not consistent with the provisions of the applicable intercreditor agreement in exercising its jurisdiction over the matter.

The terms of any particular intercreditor agreement will be influenced by the borrower's creditworthiness and capital structure, the type and terms of the relevant debt, the lender's preferred exit strategies and the general economic environment. The primary purpose of an intercreditor agreement from a senior lender's perspective is to ensure that it is in a position to control the enforcement proceedings with respect to a defaulting borrower until the senior lender is repaid in full or is no longer prepared to continue. Intercreditor agreements also typically include provisions that deal with the relative priority of liens on the collateral, the application and turnover of proceeds derived from the collateral, payment restrictions or blockage periods with respect to junior debt payments, restrictions on the type and amount of senior debt that ranks prior to more junior debt, standstill periods and other restrictions on enforcement proceedings by holders of junior debt, access rights to certain collateral, restrictions on certain modifications to the terms of each lender's credit documentation, refinancing rights and the right of junior debt-holders to purchase the senior debt. Triggers for junior debt payment blockages, the frequency and length of payment blockage periods as well as the right to make catch-up payments once a payment blockage has ceased are often heavily negotiated. The elements and amount of senior debt (including interest rate and fee increases, over advances, prepayment premiums and hedging obligations) that rank in priority to the junior secured debt are also frequently the subject of much discussion.

V JURISDICTION

It is not uncommon for acquisitions in Canada to be financed by foreign lenders based in financial centres such as New York or London. This occurs most often when the buyer is foreign or the Canadian target is part of a larger cross-border or international corporate structure. Foreign lenders often expressly choose to have their principal financing agreement governed by the law of their home jurisdiction and to stipulate that any resulting disputes will be governed by that law. In these circumstances, foreign lenders need to understand how choice of law and foreign judgments are treated in Canada and whether consent to jurisdiction clauses is enforceable.

i Choice of law

Generally speaking, in a proceeding in Canada to enforce a foreign law-governed document, Canadian courts will, with limited exceptions, apply the law expressly chosen by the parties, as long as the choice of the foreign law in the agreement is *bona fide*, legal and not contrary to public policy. Canadian courts will apply local law to procedural matters and apply local laws that have overriding effect. In addition, Canadian courts will not apply foreign law if to do so would have the effect of enforcing a foreign revenue, expropriation or penal law.

In the unlikely event that the parties do not expressly choose a system of law to govern the primary financing agreement, Canadian courts will apply the law that has the closest and most real and substantial connection to the agreement.

ii Enforcement of foreign judgments

Without reconsidering the merits, and subject to certain defences, Canadian courts generally will issue judgments in Canadian dollars based on final and conclusive foreign judgments rendered against the person for a specified amount if the action in Canada is brought within any applicable limitation period. Under certain circumstances, our courts have the discretion to stay or decline to hear an action based on a foreign judgment. Such actions may also be affected in the courts by bankruptcy, insolvency or other similar laws affecting creditors' rights.

Certain defences are available to debtors in Canada to prevent recognition and enforcement of a foreign judgment against them. The foreign judgment cannot have been obtained by fraud or in a manner contrary to natural justice. In addition, the foreign judgment cannot be for a claim that under Canadian law would be characterised as being based on a revenue, expropriatory or penal law; nor can the foreign judgment be contrary to public policy. Finally, our courts will not enforce the foreign judgment if it has already been satisfied or is void or voidable under the foreign law.

iii Submission to jurisdiction clauses

Agreements to submit all disputes related to the financing transaction to a specified jurisdiction are common in commercial financing agreements, and can be exclusive or non-exclusive. Under Canadian law, non-exclusive jurisdiction clauses have historically been held to be enforceable. Recent Canadian case law, including decisions from the Supreme Court of Canada, has strongly supported enforcement of exclusive jurisdiction clauses in order to increase predictability and certainty in the Canadian market.

VI ACQUISITIONS OF PUBLIC COMPANIES

In Canada, acquisitions of public companies are generally implemented through takeover bids pursuant to which the acquirer bids for the shares of the target (and which may or may not be followed by a compulsory acquisition of those shares that are not tendered into the bid or a second stage going private transaction); a plan of arrangement (whereby a solvent company can pursue a broad range of fundamental changes under a single transaction that is court approved); or an amalgamation of the target company with the acquirer. In Canada, acquisitions of public companies are generally effected by way of a takeover bid or plan of arrangement.

In each of the foregoing cases, where the consideration to be paid for the shares of the target will be satisfied in whole or in part in cash, an acquirer will generally incur as much debt as possible (often using the assets and credit rating of the target company as collateral) to finance the going private transaction. While, in recent years, the availability of financing has been restricted, there is now a resurgence in acquisitions being financed by more significant amounts of debt and a rejuvenation of the highly leveraged buyout market.

There are several issues that are unique to the financing of acquisitions of public companies in Canada. While many of these issues vary based on the specific provincial corporate and securities laws that are applicable in any given transaction, the general approach and issues raised are common in all Canadian jurisdictions.[24]

i Conditionality and certainty of funds

Canadian securities laws establish a 'certainty of funds' requirement for takeover bids of Canadian public companies. By way of example, Section 97.3 of the Ontario Securities Act states that where a bid provides that the consideration for the securities deposited under such bid is to be paid, in whole or in part, in cash, 'the offeror shall make adequate arrangements before the bid to ensure that the required funds are available to make full payment for the securities that the offeror has offered to acquire'.[25] In addition, the financing arrangements can be subject to conditions only if, at the time the bid is commenced, 'the offeror reasonably believes the possibility to be remote that, if the conditions of the bid are satisfied or waived, the offeror will be unable to pay for the securities deposited under the bid due to a financing condition not being satisfied'.[26]

In practice, the 'adequate arrangement' test will generally be satisfied by the offeror obtaining a binding commitment letter from its financing source that contains only limited customary conditions. Conditions that are viewed as generally being acceptable include those that mirror the conditions in favour of the offeror contained in the bid documents or that are otherwise reasonably easy for the offeror to satisfy (such as the completion of a definitive credit agreement and related loan documents). Conditions that would be unacceptable in this context would include conditions that are in the discretion of the lenders, such as satisfactory due diligence or satisfaction with the capitalisation or ownership of the target following completion of the bid.

ii Two-stage transaction

Generally, acquisition financings are secured by, *inter alia*, the collateral of the target company. In fact, the credit rating and the value of the assets owned by the target company are significant components in the lenders' analysis of the amount of credit they are willing to provide to finance an acquisition. In connection with an acquisition where the offeror aims to acquire all of the outstanding shares of the target company, the minimum tender condition is generally set at 66⅔ per cent (75 per cent for some jurisdictions). This allows the offeror to achieve a certain level of security regarding the outcome of the bid.

If an offeror acquires more than 90 per cent of the securities subject to the bid (excluding those previously held by it), both Canadian federal and provincial legislation provides for a procedure for the compulsory acquisition of the balance of the shares within a certain period of time. In the event less than 90 per cent but more than 66⅔ per cent (75 per cent for some jurisdictions) of the outstanding securities are acquired, the offeror can complete the acquisition of 100 per cent of the securities of the target company by means of a subsequent going private transaction. In this circumstance, the offeror can vote the shares

24 We have focused on the laws of the province of Ontario in our analysis of these issues below.

25 Securities Act, RSO 1990, Chapter S.5, Section 97.3(1).

26 Securities Act, RSO 1990, Chapter S.5, Section 97.3(2).

that were tendered to it under the bid. Since the voting threshold under applicable law for approval of a going-private transaction is 66 2/3 per cent (75 per cent for some jurisdictions) of the shares voting at the shareholders' meeting called to approve such transaction, the offeror can be assured that the transaction will be approved.

The foregoing has a direct impact on a lender's ability to take security over the assets of the target company. Such security cannot be granted until the offeror acquires 100 per cent of the shares of the target. The lenders will have to advance funds under the credit agreement at such time as the minimum bid condition is satisfied to enable the offeror to acquire the number of securities tendered but before it is able to obtain a security interest in the assets of the target. However, it is essentially a certainty that once such minimum number of shares is tendered to the bid, the offeror will be able to acquire 100 per cent of the target in due course.

iii Disclosure requirements

There are disclosure requirements under Canadian securities laws with respect to the terms of a financing related to the acquisition of a public company. In Ontario, for example, in the context of a takeover bid where a financing is involved, the takeover bid circular must state the name of the lender, the terms and financing conditions of the loan and the circumstances under which the loan must repaid.[27] These disclosure requirements are easily satisfied by including a summary of the terms and conditions of the financing in the circular.

VII OUTLOOK

Secured debt continues to be a popular source of funds for Canadian borrowers although lending activity is somewhat volatile. We expect that Canadian borrowers are taking advantage of low interest rates, market liquidity and favourable financing terms by securing debt financing to fund acquisitions, the refinancing of existing debt with more onerous terms, dividend and other balance sheet restructurings. In addition, we expect that the trend of Canadian borrowers amending (including repricing) and extending their credit facilities prior to maturity will continue given the favourable conditions in the Canadian debt market in light of the fact that interest rates generally are expected to increase at some point in 2017.

The high-yield market in Canada has been a difficult one for borrowers this year. Only one Canadian dollar-denominated high-yield note issuance was completed in 2015 and none appears to have been completed in 2016. As a result, Canadian borrowers are increasingly turning to the US high-yield market to raise funds and are generally finding that they must pay a premium compared with US borrowers in that market for their offerings to be successful.

As US sponsors become more active in Canada and seek financing from Canadian lenders for their Canadian acquisitions, covenant-lite loans are becoming more common in Canada. Covenant-lite loans generally do not include financial maintenance covenants or include them only on a springing basis based on certain leverage levels. Equity cures of

27 Ontario Securities Commission Rule 62-504 Take-Over Bids and Issuer Bids, OSC Rule 62-504F1 at item 12.

financial covenant breaches are generally permitted. As financial covenant breach is often an early indicator of financial difficulty, the downside for lenders is that they may not be able to trigger a default based on a financial covenant breach and initiate restructuring discussions at an early stage when more options are available to address the borrower's financial issues.

Unitranche lending has also gained some popularity with Canadian borrowers, particularly those exposed to US lenders through their US affiliates. Unitranche facilities combine senior and junior debt into one credit facility with the lenders addressing their respective priorities with a first-out, last-out mechanism under an agreement among lenders.

Chapter 7

CAYMAN ISLANDS

Charlie Pywell [1]

I OVERVIEW

The majority of merger and acquisition activity (and the financing thereof) involving exempted companies or exempted limited partnerships[2] in the Cayman Islands is originated in either England or the United States. The Cayman Islands is recognised as a leading offshore jurisdiction through which much of such merger and acquisition activity is structured.

The Cayman Islands is a tax-neutral jurisdiction, offering a robust and straightforward legal and regulatory system based on English common law. Much like England, the legal system in the Cayman Islands is well regarded as creditor-friendly (with the absence of debtor-friendly insolvency regimes such as Chapter XI in the United States) which is clearly attractive to lenders and helps to increase liquidity in leveraged finance structures involving Cayman Islands holding companies.

There are few restrictions in the Cayman Islands on the type of recognised debt products that may be used to finance the acquisition of entities incorporated in the Cayman Islands (which, for ease, will be referred to in this chapter as 'Cayman companies'). Accordingly, all of the 'usual' leveraged finance debt products are available in the Cayman Islands. These

1 Charlie Pywell is a senior associate at Conyers Dill & Pearman.

2 The scope of this chapter is limited to Cayman Islands exempted companies. Exempted companies feature in the vast majority of international transactions involving the Cayman Islands. Exempted companies (and exempted limited partnerships) are registered on the basis that their objects are to be carried out mainly outside of the Cayman Islands. This is in contrast to ordinary resident companies, which conduct their operations primarily within the Cayman Islands. Please also see Section VII, *infra*, in relation to limited liability companies. As this is a newly introduced corporate vehicle in the Cayman Islands, it is not separately considered, although many processes described in this chapter would apply equally to limited liability companies.

include: secured bank term facilities (including senior secured, mezzanine and second-lien term loans); notes or bonds and bridge facilities (including high yield, senior secured, second lien and privately placed); and working capital and revolving credit facilities.

The type of debt product used in leveraged acquisitions involving Cayman companies is driven by the commercial needs of the specific deal (rather than jurisdictional issues arising in the Cayman Islands). 'Mid-market' acquisitions are typically financed with secured-term bank lending (typically senior and mezzanine term debt for acquisitions originating in Europe and first and second-lien term debt for acquisitions originating in the United States). In higher-value acquisitions, it is common for high-yield or senior secured notes (or both) to be issued. In both cases, it is common for revolving facilities to be made available to the target group (primarily for working capital purposes) under secured bank lending arrangements (and where the acquisition is structured using senior secured notes, it is typical for such revolving facilities to rank 'super senior' to such senior secured notes).

Irrespective of the combination of debt products used, such debt is typically guaranteed by each material subsidiary and the direct parent of the borrower. The finance documents (other than jurisdiction specific security documents) are typically governed by English or New York law (depending on the originating jurisdiction).

The mergers and acquisitions market in the Cayman Islands in 2015 and the first quarter of 2016 was buoyant. The total deal value for corporate activity in the Cayman Islands in 2015 was US$125 billion, with nearly 1,000 deals representing a third of the deal volume for the entire offshore region.[3] During 2015, 11,875 exempted companies[4] and 3,377 exempted limited partnerships[5] were formed in the Cayman Islands and, as at 24 June 2016, there were a total of 101,289 companies[6] and 19,021 exempted limited partnerships[7] registered in the Cayman Islands. Macroeconomic and political uncertainty in Europe will, however, likely have some negative impact on deal activity in the second half of 2016 and into 2017.

II REGULATORY AND TAX MATTERS

i Licensing

The banking sector (*inter alia*) is regulated in the Cayman Islands by the Cayman Islands Monetary Authority (CIMA). Financial institutions are required to be licenced by the CIMA if they are carrying out 'banking business' – which is defined as 'the business of receiving (other than from a bank or trust company) and holding on current, savings, deposit or other similar account money which is repayable by cheque or order and may be invested by way of advances to customers or otherwise'.[8]

It is not necessary for a foreign financial institution that is simply lending to a Cayman company to be licensed, qualified or otherwise entitled to carry on business in the Cayman Islands. In addition, a financial institution lending to a Cayman company will not be deemed

3 Appleby's 'Offshore-i' annual report for 2015.
4 Cayman Islands Register of Companies.
5 Cayman Islands Register of Exempted Limited Partnerships.
6 Cayman Islands Register of Companies.
7 Cayman Islands Register of Exempted Limited Partnerships.
8 Banks and Trust Companies Law (2013 Revision).

to be resident, domiciled or carrying on business in the Cayman Islands by reason only of the execution, performance or enforcement of the relevant finance documents (including any Cayman law governed security documents) by such financial institution.

Lenders that are carrying out 'banking business' are required to be appropriately licensed by the CIMA, but such requirements are beyond the scope of this chapter.

ii Sanctions, anti-corruption and anti-money laundering

Local sanctions, anti-corruption, anti-money laundering and anti-terrorism financing legislation and regulations have been adopted in the Cayman Islands in line with other major offshore financial centres and onshore jurisdictions. Such laws in the Cayman Islands require financial institutions to apply a risk-based approach to money laundering and to implement risk management policies (including customer due diligence and suspicious activity reporting).

As EU and international laws relating to sanctions are also presently adopted in the Cayman Islands and such legislation is regularly revised, it is important to ensure that the relevant legislation is reviewed on an ongoing basis.

iii Tax

General

There are no income, corporation, capital gains or other taxes presently in effect in the Cayman Islands which generally affect Cayman companies. A Cayman company can apply for (and expect to receive from the Governor-in-Cabinet of the Cayman Islands), pursuant to the Tax Concessions Law of the Cayman Islands, an undertaking that in the event of any change to the foregoing, such Cayman company, for a period of 20 years from the date of the grant of the undertaking, will not be subject to tax in the Cayman Islands on its income or its capital gains arising in the Cayman Islands (or elsewhere) and that dividends of such company will be payable without deductions of Cayman Islands tax. It is typical for Cayman companies to obtain such an undertaking upon incorporation (but it may be obtained at any time thereafter).

Stamp duty and documentation

There is no stamp, registration or similar tax or duty to be paid on or in relation to any finance documents provided that they are executed and remain outside the Cayman Islands. If it becomes necessary to bring any of the finance documents into the Cayman Islands (for enforcement or otherwise) nominal stamp duty will be payable. In the case of any finance document creating security over moveable property situated in the Cayman Islands or over shares in a Cayman company, stamp duty will be payable on an *ad valorem* basis to a maximum of CI$500.

Withholding tax and the Cayman Islands Stock Exchange

As above, there is no income, corporation, capital gains or other taxes presently in effect in the Cayman Islands and, accordingly, no withholding tax is applied in the Cayman Islands on payments to or from Cayman companies.

There is, however, a steady stream of Cayman and non-Cayman companies making 'technical listings' of debt securities (typically intercompany loan notes) on the Cayman Islands Stock Exchange (CSX). A principal reason for doing so is to benefit from the well-publicised quoted Eurobond exemption. The CSX has been designated a 'recognised stock exchange' by

HM Revenue & Customs in the United Kingdom, meaning that an issuer that is tax-resident in the UK can make payments of interest on such listed debt securities gross, without any deduction for tax. As at December 2015, quoted Eurobond securities with an aggregate face value of US$83.9 billion had been listed on the CSX (which constitutes more than 40 per cent of the total aggregate value of debt securities listed on the CSX).[9]

III SECURITY AND GUARANTEES

i Guarantees

The provision of a guarantee by a Cayman company of the debts and other obligations of companies within the same group is a common feature of leveraged financings involving Cayman companies. The guarantee is typically documented under the same governing laws as the underlying finance documents to which it relates and is generally included within the facility agreement (or occasionally the intercreditor agreement). Guarantees are often granted by the direct parent of the borrower of the acquisition debt (which is typically a newly formed vehicle established for the purpose of making the acquisition of the target company) and are ordinarily granted by all subsidiaries (or, increasingly commonly, just the material subsidiaries) of the borrower by way of accession to the main finance documents within an agreed time frame post-acquisition.

There are no legislative or other restrictions on the ability of a Cayman company to provide financial assistance (i.e., the ability of a Cayman company to guarantee or secure borrowings incurred to finance or refinance the direct or indirect acquisition of the shares of such Cayman company or any of its holding companies or sister companies). There are also no restrictions imposed by Cayman Islands law on the amount of any guarantee that a Cayman company may provide, although, as set out below, the directors of a Cayman company have a duty to consider the corporate benefit to that company in entering into any such transaction.

ii Security

Cayman Islands law does not place any restrictions on the categories of assets that can be subject to security and, accordingly, any or all of the property of a Cayman company is available as collateral.

Cayman Islands law generally recognises six forms of security interest: (1) a legal mortgage; (2) an equitable mortgage; (3) a charge; (4) a pledge; (5) a lien; and (6) an assignment by way of security. The most common types of security interests granted by or over a Cayman company are equitable mortgages, charges and security assignments. In the context of leveraged financings involving Cayman companies, legal mortgages, pledges and liens are so rarely granted that a discussion of them is beyond the scope of this chapter.

Mortgages and charges

Although they are conceptually different, the practical distinction between an equitable mortgage and a charge is not significant. In each case, the security is effective without any necessity for the secured parties to be in possession of the secured asset and both give the

9 Cayman Islands Stock Exchange.

secured parties a proprietary interest in the secured asset which is effective on the insolvency of the grantor of that mortgage or charge. Both mortgages and charges may be granted over current and future-owned assets.

In the case of a mortgage, title to the asset is transferred to the secured party (although in the case of an equitable mortgage, only beneficial title is transferred with legal title remaining with the mortgagor). The transfer of title pursuant to a mortgage is a transfer by way of security, meaning that it has been transferred only to secure an obligation and, accordingly, once that obligation is discharged, the mortgagor is entitled to have that title transferred back to it. This right, which is itself a proprietary interest, is described as the 'equity of redemption'. The equity of redemption cannot be extinguished without the express order of a court (for example, an order for foreclosure).

A charge is distinguishable from a mortgage on the basis that it is a proprietary interest granted by way of security without a transfer of title or possession.[10] A charge creates a security interest which attaches to a particular asset and generally travels with it into the hands of a third party (except where the charged asset is transferred to a *bona fide* purchaser of full legal title for value and without notice of the existence of the charge, in which case such purchaser will acquire the asset free of the charge).

Charges are characterised as being either fixed or floating and, in practice, where a company has a range of different types of asset available to secure its debts or other obligations, fixed and floating charges will be created within a single charge document (and where such fixed and floating charges are created over substantially all of the assets (and potential assets) of a company, the document creating such charges is usually called a debenture). Irrespective of how a charge is described in the document creating it, its characterisation as either a fixed or a floating charge will principally depend on the level of control the chargor retains over the asset in question and the extent to which the chargor is able to continue to deal with the asset.[11] Accordingly, the document under which a purported fixed charge is created will, subject to commercial agreement to the contrary, usually contain restrictive provisions that are designed to prevent the chargor from dealing with the assets subject to the fixed charge. In contrast to a fixed charge (which attaches to specific assets), a floating charge is a security interest over the assets of a company (which may be all or a specified class of assets) which is said to 'float' over the charged assets until such time as it 'crystallises', at which point it is converted into a fixed charge.

The significance of correctly characterising a charge is apparent on the insolvent winding up of a company. As set out in Section IV, *infra*, claims by the holders of fixed charges will rank in priority to the claims of certain preferred creditors and to the holders of floating charges. Despite this lower priority, lenders often seek to take a floating charge as 'back-up' to purported fixed charges. Floating charges have the benefit of providing a security interest while not restricting the ability of the chargor to carry on its business operations.

Except for real estate, aircraft and ships, there is no statutory regime in the Cayman Islands for the creation of charges or mortgages; they are created by the execution of a security

10 *Re Bank of Credit and Commerce International (No. 8)* [1998] AC 214 at 226 – which would be highly persuasive in the Cayman Islands courts.

11 *National Westminster Bank plc v. Spectrum Plus Limited and others* [2005] UKHL 41 – which, again, would be highly persuasive in the Cayman Islands courts.

agreement between the chargor and the secured creditor (typically a security agent or trustee on behalf of several secured parties). This agreement will evidence the grant of the mortgage or charges (fixed or floating or both) and will set out their terms.

Assignments by way of security

Security may be granted by a Cayman company over claims and receivables to which it is entitled and, most commonly, over debts and other rights created by contract. A claim or receivable arising under a contract is classified as a chose in action, being a right that can only be asserted bringing a legal action and not by taking possession of a physical asset. Consequently, a security interest over such assets takes the form of an assignment with an express or implied undertaking to reassign the asset on discharge of the secured obligation (as noted above, the 'equity of redemption'). An assignment by way of security may be either legal (with the giving of notice to the counterparty to such assigned contract) or equitable (where no such notice is given or for such time until notice is given).

The terms of the contract under which the debt or other chose in action arises must be considered before any security assignment is created to ensure, among other things, that the assignment of such rights is not prohibited or subject to consent of the debtor. Failure to comply with such contractual terms will render any purported assignment of such rights invalid against the debtor.

iii Secured assets

As noted above, any or all of the property of a Cayman company is available to be secured. However, as Cayman companies involved in leveraged financings are most commonly existing holding companies or newly incorporated acquisition vehicles, it is regularly the case that the only real asset of a Cayman company is the shares it holds in its subsidiaries. Accordingly, the most common category of asset secured in leveraged financings involving Cayman companies is the shares of a Cayman company. Security over the shares of Cayman companies will typically be governed by Cayman Islands law although it is not uncommon for security to be taken over the shares of a Cayman company under foreign laws (particularly New York law).

To the extent that a Cayman company has other assets with their *lex situs* in the Cayman Islands, Cayman Islands law governed security may be taken over them. Considering the nature of Cayman Islands-exempted companies (which are registered on the basis that their objects are to be carried out mainly outside the Cayman Islands), it is uncommon for such companies to have fixed assets located in the Cayman Islands. However, it is not uncommon for Cayman companies to have bank accounts located in the Cayman Islands and they may also have the benefit of certain contracts governed by Cayman Islands law (typically evidencing intra-group receivables).

A security interest in a bank account will normally take the form of a charge over all money standing from time to time to the credit of specified accounts together with an assignment by way of security of interest and all other rights and benefits accruing to, or arising in connection with, such accounts. As set out above, a security interest over claims and receivables, typically debts and other rights created by contract, will normally take the form of an assignment by way of security (on the basis that a claim or receivable arising under a contract is a chose in action, being a right which can only be asserted by bringing a legal action and not by taking possession of a physical asset).

On the rare occasions where a Cayman company has multiple classes of assets located in the Cayman Islands or, more likely, where the finance parties are keen to ensure they have security over all future assets of a Cayman company (but the likely location of such assets is unknown at the time of entering into the transaction), a Cayman company may execute a Cayman Islands law governed fixed and floating charge document, creating security over all of its present and future assets. Such a document is substantially similar in both form and substance to an English law-governed debenture.

Security over shares of a Cayman company

Security over shares of a Cayman company may be created either as a legal mortgage, an equitable mortgage or a charge. It is not possible to 'pledge' a registered share under Cayman Islands law because a pledge necessarily requires title to the secured asset to be transferred by delivery, which, in the case of a share in a Cayman company, is not possible as legal title to shares in Cayman companies is transferred by an instrument of transfer. It is, however, quite common for security documents over shares in Cayman companies that are governed by foreign laws (particularly in the United States) to describe such security as a pledge. It is likely that such a 'pledge' will, by its terms, have the effect of creating a charge over the registered shares; however, in some cases it may be ineffective in doing so. For numerous reasons, it is extremely uncommon for a legal mortgage to be taken over shares in a Cayman company (i.e., where there is a transfer of legal title to such shares). These reasons include that the secured party may be required under applicable accounting rules to consolidate the company. Accordingly, security over shares of a Cayman company is ordinarily taken in the form of an equitable mortgage of those shares, with a fixed charge over the rights with respect to such shares.

The security document creating such equitable mortgage and charge will include a provision requiring that the Cayman company (whose shares are subject to the security) maintains its register of members in the Cayman Islands. The *situs* of shares issued by a Cayman company is determined under Cayman Islands conflict of law principles by the location of the register of members and different rules to those set out in Section IV may apply if the register of members is maintained outside the Cayman Islands.

A Cayman Islands law-governed equitable mortgage and charge over shares and related rights is, in form and substance, similar to an English law-share charge. However, the market in the Cayman Islands has developed such that it is common to require certain deliverables in addition to those ordinarily required by English-law share charges (which are usually limited to the delivery by the chargor of an undated signed share transfer form and the share certificates representing the secured shares). In addition to the delivery of an undated share transfer form and all share certificates representing the secured shares,[12] a Cayman Islands law-governed equitable mortgage and charge over shares will typically require the delivery by the mortgagor of some or all of the following additional documents which will facilitate enforcement and improve the quality of the security (and which are often referred to as 'self-help remedies'):

12 Note that there is no legal requirement in the Cayman Islands for a Cayman company to issue share certificates to its shareholders. Accordingly, the obligation to deliver share certificates to the secured party only applies to the extent that such share certificates exist.

a an irrevocable proxy[13] to enable the secured party to attend and vote the shares at general meetings of the company following the security becoming enforceable in accordance with its terms;

b an undated resignation letter signed by each existing director of the company (and an obligation for future directors to provide the same), together with a letter of authority addressed to the secured party authorising it to date the letter of resignation on enforcement of the security;

c a deed of undertaking given by the company to the secured party acknowledging the equitable mortgage and charge and undertaking to register all share transfers delivered to the company by the secured party pursuant to the security document;[14] and

d a letter of direction from the company to its registered office service provider,[15] instructing it to enter in the register of members of the company any share transfers delivered by the secured party pursuant to the terms of the security document.

As Cayman companies often act as holding companies of the borrower group, an equitable mortgage or charge over the shares of a Cayman company is likely to be of particular importance to the finance parties as it may provide a single point of enforcement whereby the secured party can effectively sell the whole group on enforcement without having to coordinate the enforcement of multiple share charges (in multiple jurisdictions).

iv Perfection of security and registration of security interests

Perfection

The formalities for the perfection of a particular security interest will usually depend on the type of secured asset, the security interest created and the *lex situs* of such asset. In general, legal mortgages and legal assignments are the only types of security interest which may be perfected under Cayman Islands law.

Perfection of a legal mortgage involves the transfer of legal title to the secured asset to the secured party (or its nominee) while perfection of a legal assignment requires written notice to be given to the counterparty to the underlying contract. Special statutory regimes prescribe the steps to be taken to secure interests in real estate situated in the Cayman Islands or ships and aircraft registered in the Cayman Islands (including the entry of prescribed details in certain public registers).

13 An irrevocable proxy will only be effective where it is provided for in the articles of association of the company. The English case of *Cousins v. International Brick Co Ltd* [1931] 2 Ch 90 (CA), which has persuasive authority in the Cayman Islands courts, is authority for the general rule that a shareholder attending and voting at a general meeting of a company will take priority over and to the exclusion of a proxy holder in attendance and wishing to vote at the same meeting.

14 Such an undertaking may be contained within the security document if the company is party to that document creating security over its shares.

15 The registered office of a Cayman company is typically provided by a licensed third party service provider that (unless the register is maintained elsewhere) will maintain the company's register of members and update it when instructed to do so by or on behalf of the company.

Under Cayman Islands law, perfection of equitable security interests is not possible and there are no public registers in which equitable security interests may be recorded in the Cayman Islands.

Register of mortgages and charges

Although there are no public registers in which security interests may be recorded (save for those referenced above in relation to real estate, ships and aircraft), every Cayman Islands company has a statutory obligation under the Companies Law (2013 Revision) of the Cayman Islands (the Companies Law) to keep at its registered office a register of all mortgages and charges affecting the property of that company and including certain prescribed details with respect to such mortgages and charges.[16]

A failure to enter the details of a mortgage or charge in the company's Register of Mortgages and Charges does not invalidate the security created (or otherwise affect its enforceability), but there are statutory penalties for every director, manager or other officer of the company who knowingly and wilfully authorises or permits the omission of such entry.

v Security agent

Cayman Islands law follows English trust law principles and will recognise and enforce foreign trusts in accordance with their governing law (subject to the limited caveats set out in Section V, *infra*), including the appointment of an agent or trustee to hold security on behalf of the secured creditors. Accordingly, there is no need to apply any 'parallel debt' provisions in the finance documents to Cayman companies.

vi Potential limitations

Corporate benefit

There is no statutory regime in the Cayman Islands governing directors' fiduciary duties and, accordingly, such duties are based on common law principles. The most relevant of these duties in the context of a leveraged financing (and the related provision of guarantees and security) is the duty to act in the best interests of the company as a whole, which is intrinsically linked to the issue of corporate benefit. The directors of a Cayman company providing any guarantee or security should always consider the corporate benefit to that company in doing so and should consider whether, in all the circumstances, the provision of such guarantee and security would be in the best interests of that company. If a Cayman company receives little or no discernible commercial benefit from the provision of guarantees and security, there is a risk that a Cayman Islands court may set aside such guarantees and security on the basis that the directors have breached their fiduciary duties to act in the best interests of the company.[17]

There is little difficulty in showing there is corporate benefit to a Cayman company in providing a downstream guarantee for the obligations of a subsidiary. Likewise, there is a well-versed argument that, in the context of a financing transaction that is of benefit to the whole group, an indirect commercial benefit will accrue to a Cayman company that is providing upstream, cross-stream and down-stream guarantees. Accordingly, in the context of most leveraged financings involving Cayman companies, although the issue of corporate

16 Section 54 of the Companies Law.

17 On an action brought by a shareholder, creditor or liquidator.

benefit is something that should be considered, it will rarely result in the directors of a Cayman company determining that the company cannot provide a guarantee or security in support of obligations owed by other members of the group.

To avoid the risk of the validity of a guarantee being challenged by a shareholder, it is common for the secured parties to require that the Cayman company providing guarantees and security obtains the approval of its shareholders to effectively 'whitewash' the transaction before it is consummated.

Voidable transactions

Security granted by a Cayman company (and the enforceability of the documents under which such security is granted) is subject to the insolvency rules generally applicable to companies in the Cayman Islands, which include rules that invalidate transactions which constitute a voidable preference or a disposition made at an undervalue.

Every conveyance or transfer of property, any charge and every payment obligation which is made, incurred, taken or suffered by any company in favour of any creditor, at a time when that company is unable to pay its debts, with a view to giving such creditor a preference over the other creditors of that company shall be invalid if it is made, incurred, taken or suffered within six months immediately preceding the commencement of a liquidation of that company.[18] Note that there is no requirement that such a preference is made to a related party. However, the Companies Law provides that any such transaction in favour of a related party shall be deemed to have been made with a view to giving such related party a preference.[19]

The Companies law further provides[20] that every disposition of property made at an undervalue[21] by or on behalf of a company with intent to defraud its creditors[22] shall be voidable at the instance of its official liquidator. The burden of establishing an intent to defraud is on the liquidator and any action by a liquidator with respect to this provision must be brought within six years from the date of the relevant disposition.

IV PRIORITY OF CLAIMS

i Priority

On a liquidation of a Cayman company, the following categories of debts and creditors are paid in the following order: (1) expenses incurred in the winding-up (including the

18 Section 145 of the Companies Law.

19 A creditor is treated as a related party if it has the ability to control the company or exercise significant influence over the company in making financial and operating decisions. Section 145(3) of the Companies Law.

20 Section 146 of the Companies Law.

21 Meaning either there is no consideration or that the consideration for the disposition in money or monies worth is 'significantly less' than the value of the property disposed, Section 146(1)(e) of the Companies Law.

22 Being an intention to wilfully defeat an obligation owed to a creditor, Section 146(1)(b) of the Companies Law.

liquidator's remuneration);[23] (2) secured creditors with fixed charges; (3) creditors with respect to preferred debts;[24] (4) secured creditors with floating charges; (5) unsecured creditors; and (6) shareholders.

A creditor who has security over the whole or part of the assets of a company is entitled to enforce his security without the leave of the courts and without reference to the liquidator.[25] Accordingly, secured creditors may, subject to the contractual terms of the document creating the security interest, enforce their security at any time (whether or not liquidation proceedings have begun). Assuming a secured creditor exercises its right to enforce its security outside of the insolvency proceedings, its claims will be satisfied ahead of other claims.

Priority as between competing security interests in the same asset is generally determined under the *lex situs* of the asset. The discussion below relates solely to priority in relation to assets that are situated or otherwise governed by the laws of the Cayman Islands and does not extend to priority under the laws of other jurisdictions, where different rules may apply that are beyond the scope of this chapter. The Cayman law position regarding competing security interests (over assets with their *lex situs* in the Cayman Islands) is largely taken from English common law.

A legal mortgage takes priority over all other security interests in the same asset granted later in time, but will rank behind an earlier equitable mortgage or charge, the existence of which the holder of the legal mortgage had actual knowledge at the time such legal mortgage was created. Fixed charges rank in the order in which they are created and consequently a fixed charge created earlier in time will take priority over one created later in relation to the same asset.

A floating charge will generally rank after a subsequent fixed charge over the same asset, unless the holder of such fixed charge has actual notice of a negative pledge in favour of the holder of such floating charge prohibiting the creation of any subsequent charge over the asset; in which case the floating charge will, on crystallisation, have priority over the subsequent fixed charge.

Legal assignments (being assignments which have been perfected by the giving of notice to the counterparty to the assigned agreement) will generally rank ahead of equitable assignments (where no notice to the counterparty has been given) unless the assignee of such legal assignment had, at the time of taking the legal assignment, notice of an equitable assignment taken earlier in time.

ii Intercreditor arrangements, subordination and set-off

The Companies Law provides that the collection in and application of the property of a company by a liquidator in satisfaction of its liabilities is without prejudice to and after taking into account and giving effect to:

a the rights of preferred and secured creditors;

23 Section 109 of the Companies Law.

24 A small number of preferred debts are set out in Schedule 2 to the Companies Law. These generally relate to amounts owing to employees and are often not relevant (as most Cayman companies used in acquisition financing structures will not have direct employees).

25 Section 141(1) of the Companies Law.

b any agreement between the company and any creditors that the claims of such creditors shall be subordinated or otherwise deferred to the claims of any other creditors; and

c any contractual rights of set-off or netting of claims between the company and any person (including any bilateral or multilateral set-off or netting arrangements between the company and any person).[26] Accordingly, Cayman law recognises the existence of, and will enforce, contractual subordination provisions and set-off arrangements.

Subordination and set-off arrangements are typically included in a separate intercreditor agreement (ordinarily governed by English or New York law – depending on the origination of the deal in question) rather than in a Cayman law-governed security document. As noted above, the intercreditor agreement will also typically include trust and agency provisions pursuant to which a security agent is appointed to hold all security on behalf of the various creditors (subject to the subordination provisions set out therein).

V JURISDICTION

A *bona fide* choice of the laws of any foreign jurisdiction as the governing law of the transaction documents will be upheld as a valid choice of law and would be recognised and given effect to in any action brought before a court of competent jurisdiction in the Cayman Islands, except for those laws: (1) which such court considers to be procedural in nature; (2) which are revenue or penal laws; or (3) the application of which would be inconsistent with public policy, as such term is interpreted under the laws of the Cayman Islands. Likewise, subject to certain limitations (including the discretion of the Cayman courts to stay proceedings where proceedings involving the same issues are underway elsewhere), the courts of the Cayman Islands will recognise the submission by a Cayman company to the jurisdiction of the courts of a foreign jurisdiction and such submission is valid and binding upon such Cayman company.

As noted above, with respect to the choice of the governing law of security documents, the Cayman Islands generally follows the English common law position on conflict of laws principles. Accordingly, security documents will generally be governed by the *lex situs* of the relevant secured asset save for where it is more practicable to take security over various assets of a company (which may be located in various jurisdictions) under one document (for example, under a debenture).

Subject to some limited caveats (which are unlikely to relevant in the context of a leveraged finance transaction), the courts of the Cayman Islands will recognise as a valid judgment, a final and conclusive judgment *in personam* obtained in the courts of a foreign jurisdiction against a Cayman company based upon the relevant transaction documents under which a sum of money is payable (other than a sum of money payable in respect of multiple damages, taxes or other charges of a like nature or in respect of a fine or other penalty) or, in certain circumstances, an *in personam* judgment for non-monetary relief, and would give a judgment based thereon provided that:

a such courts had proper jurisdiction over the parties subject to such judgment;

b such courts did not contravene the rules of natural justice of the Cayman Islands;

c such judgment was not obtained by fraud;

26 Section 140(2) of the Companies Law.

d the enforcement of the judgment would not be contrary to the public policy of the Cayman Islands;

e no new admissible evidence relevant to the action is submitted prior to the rendering of the judgment by the courts of the Cayman Islands; and

f there is due compliance with the correct procedures under the laws of the Cayman Islands.

VI ACQUISITIONS OF PUBLIC COMPANIES

Cayman corporate law does not distinguish between public and private companies. However, the shares of a Cayman company may be listed, either on the CSX or (more commonly) on exchanges in other jurisdictions. In addition to listings on the Hong Kong Stock Exchange (which is the most popular exchange for listing Cayman company equity securities), shares of Cayman companies are listed on NASDAQ, the London Stock Exchange and the New York Stock Exchange, *inter alia*. On an acquisition of the shares of a Cayman company that are listed, the parties should ensure compliance with any takeover code that applies in the relevant jurisdictions and the listing rules applicable to the relevant exchange.

If the shares to be acquired are listed on the CSX then the Cayman Islands Stock Exchange Code on Takeovers and Mergers and Rules Governing Substantial Acquisitions of Shares (the Code) will apply and should be complied with. In contrast to the listing of debt securities on CSX (discussed above in relation to the quoted Eurobond exemption), there are only a small number of companies (other than investment funds) with equity securities listed on CSX and those are primarily 'technical listings' where the securities are not traded. Accordingly, a discussion of the terms of the Code is beyond the scope of this chapter.

In the majority of leveraged acquisitions involving Cayman companies, the Cayman companies involved are non-listed existing holding companies or newly incorporated acquisition vehicles. However, for acquisitions of Cayman companies whose shares are listed on a stock exchange, or where the shares are not listed but are widely held, there has been significant rise in the use of the statutory merger provisions in the Cayman Islands[27] to effect such acquisitions.

The statutory merger provisions in the Cayman Islands are based on the Delaware statutory merger regime and first came into existence in 2009 (prior to 2009, there was no statutory merger regime in the Cayman Islands). These provisions allow for domestic mergers between Cayman companies and for cross-border mergers between a Cayman company and a foreign company. The most appealing aspect of the merger regime in the Cayman Islands is that the approval threshold is limited to a special resolution of the merging companies[28] and dissenter rights are limited to receiving 'fair value' for the shares.[29] Upon dissenting, a dissenting member will cease to have any rights with respect to its shares (other than the right to receive payment of fair value) and, consequently, is not able to block or otherwise impede

27 Sections 232 to 239 of the Companies Law.

28 Pursuant to the Companies Law, a special resolution requires a majority of at least two-thirds of the members as, being entitled to do so, to vote on the resolution (unless the Articles of Association of the Company stipulate a higher threshold).

29 Section 238(7) of the Companies Law.

the progress of the merger. There is a statutory timetable for the company and the dissenter to agree on an amount representing 'fair value' and, failing this, the company must (and the dissenting shareholder may) petition the Cayman courts to determine the same.

With such a low squeeze-out threshold and dissenter rights limited to receiving 'fair value', the Cayman Islands merger regime is now the principal means of effecting acquisitions of Cayman Islands companies, although schemes of arrangement and tender offers remain available.

VII OUTLOOK

The Cayman Islands Limited Liability Companies Law 2016 came into effect on 8 July 2016, introducing a new form of corporate vehicle in the Cayman Islands: the limited liability company (LLC). The LLC is a hybrid vehicle combining many of the key characteristics of existing Cayman Islands companies and limited partnerships. The LLC is expected to be particularly attractive to sponsors from the US looking for a vehicle that is closely aligned with the Delaware LLC. While exempted companies and exempted partnerships are expected to remain as popular as ever, the introduction of the LLC will likely help maintain the attractiveness of the Cayman Islands, particularly for the investment funds industry.

The Cayman Islands has developed and continues to maintain a strong reputation for being an innovative, flexible and creditor-friendly jurisdiction and is generally regarded as the leading jurisdiction for offshore private equity funds and investment holding structures. Tax neutrality, the absence of withholding tax and the ability to easily transfer funds or pay dividends to non-resident shareholders all contribute to that position. No material changes in policy or legislation are expected that would have any impact on the leveraged finance market in the Cayman Islands in the coming year.

While political and economic uncertainty in the eurozone may well have a negative impact on deal activity in the short to medium term, the Cayman Islands is well placed as an established and flexible jurisdiction to react to market needs as the economic and political landscape evolves.

There will likely be a continuance of the increasing trend towards using the Cayman statutory merger provisions (which have been largely replicated in the LLC legislation) to effect acquisitions, particularly where the target Cayman company's shares are listed or otherwise widely held.

However, it remains to be seen whether the general increase in shareholder activism, particularly in the United States, will lead to a significant increase in the use of dissenter rights in an attempt to extract a higher value for the shares of such activist shareholders through the Cayman courts.

Chapter 8

ENGLAND & WALES

Christopher Kandel and Karl Mah[1]

I OVERVIEW

The United Kingdom has a relatively 'open market' approach to acquisitions and a long tradition of merger and acquisition activity, including leveraged buyout activity that dates back at least to the 1980s. Typical sources of finance have included commercial and investment banks, both lending directly or – for larger transactions – where they underwrite the debt initially but then syndicate it widely to investors such as other banks and institutional lenders including collateralised loan obligations (CLOs) and collateralised debt obligations (often incorporated in tax-haven jurisdictions such as the Cayman Islands) and hedge and other funds. The high-yield bond (notes) market started slowly in the 1990s, largely tapping the US market in its early days and becoming increasingly European in the first decade of the 21st century, but since 2010 it is commonly looked to particularly for larger acquisitions and refinancings. Given the usual need for certainty in the financing of an acquisition, a notes issue in connection with an acquisition is normally preceded by the underwriting banks providing a bridge loan or bridge loan commitment that is subsequently refinanced by the notes.

As a result of the credit crisis, new lenders have stepped into the market and we increasingly see funds making directly arranged loans in certain mid-market financings (in effect, cutting out the arranging banks), including through the introduction of debt products such as unitranche loans. We have also seen the development of a buoyant market in which European borrowers and acquisitions are financed with loans placed in the deeper US markets, particularly the US term loan B, covenant-lite and second-lien markets. Competition from the US loan and bond markets has resulted in a trend for European loan financings for top-tier financial sponsor-backed borrowers to have much increased convergence with the terms in the US market; the market in Europe continues to grapple with some of the structural implications of the US market terms such as the typical flexibility to incur

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unsecured debt at any guarantor (usually subject to compliance with one or sometimes two ratio tests at the time of incurrence) – this flexibility has different and adverse consequences for the more senior lenders in a European restructuring or insolvency than would be the case in a restructuring or insolvency under the US bankruptcy system.

II REGULATORY AND TAX MATTERS

England and Wales has comprehensive regulations that apply to banking and related businesses conducted in the United Kingdom. The Bank of England Prudential Regulatory Authority regulates and supervises banks, insurers and certain investment firms. Separately, authorisation is required by the Financial Conduct Authority for firms and individuals that carry out any regulated financial service market activity in the United Kingdom.

While a survey of that regulation is outside the scope of this chapter, it should be noted that simply making a secured or unsecured loan, subscribing for a secured or unsecured debt security of a borrower or issuer that is incorporated or tax-resident in England and Wales[2] (or the purchase of either from someone who has already funded such a loan or investment) does not in itself require any kind of banking or similar licence.

In common with a number of other European jurisdictions, the United Kingdom imposes withholding tax on payments of interest (and on certain other payments). Withholding tax is imposed on payments of interest that have a UK source, and the applicable withholding tax rate is currently 20 per cent. However, withholding tax can be reduced or eliminated pursuant to a number of exemptions.

First, withholding tax is typically eliminated where the beneficial owner of the interest is a UK bank, or a UK corporate lender that brings the interest into account for UK corporation tax purposes.

Second, non-UK lenders can often reduce or eliminate withholding tax pursuant to a network of bilateral tax treaties[3] that is relatively comprehensive, but that notably does not include entities that are tax-resident in the main tax-haven jurisdictions.

Third, withholding tax can be eliminated under the recently introduced 'private placement' exemption, which came into effect on 1 January 2016 (though can apply to unlisted debt securities issued prior to that date). Although the effect of the relevant rules is, in practical terms, relatively untested and use of this exemption is not currently widespread on deals, HMRC has confirmed that it is capable of applying to syndicated loans where the necessary conditions are met. Accordingly, it is possible that greater use of this exemption may be made going forwards.

Finally, there is also a 'quoted eurobond' exemption from withholding tax for interest bearing debt that is publicly listed on a recognised stock exchange regardless of the identity

2 Consumer finance lies outside the scope of this chapter; as such, regulation in that area is not addressed here.

3 Note that these tax treaties are not a creature of European Union law, so any exit from the European Union following the UK referendum on EU membership on 23 June 2016, would not in itself affect the availability of any exemptions from or reductions in the applicable rate of United Kingdom withholding tax.

of the beneficial owner of the interest. This allows UK corporates to issue high-yield notes without a withholding tax concern; however, note that of the English categories of 'legal persons', only a public limited company may issue publicly listed securities.

These exemptions are often sufficient to enable acquisition financings to be placed; in some cases where syndication of loans (whether definitive or bridge) is necessary to investors in tax-haven or other jurisdictions without a suitable tax treaty, it can be necessary to use (or add) a foreign loan borrower. Cross-border intra-group proceeds loans into the UK (in the form of notes) are occasionally listed where (for example) there is either no tax treaty between the interest paying and receiving countries or there is concern that the interest receiving entity does not have sufficient substance to qualify under the relevant tax treaty.

The UK currently has rules that allow a form of tax consolidation within a corporate group (essentially by enabling group members to surrender losses and reallocate gains between each other on a current year basis). Therefore (subject to the principles mentioned below) a UK bidco borrowing to make an acquisition of a UK operating group can, in principle, achieve deductibility of the related interest expense against operating profits in the United Kingdom. A UK group of companies for this purpose can include both companies incorporated in the UK and companies incorporated outside the United Kingdom that are UK tax-resident by virtue of being centrally managed and controlled in the United Kingdom.

UK tax law has a number of principles that can limit deductibility of interest. These include limitations in respect of interest that is not considered to be 'arm's length' under thin-cap and transfer-pricing principles, interest that has equity-like characteristics and interest that is considered to have been incurred for a tax avoidance purpose. In addition, as part of the 2016 Budget, the United Kingdom government confirmed its intention to introduce new corporate interest deductibility rules from 1 April 2017 in line with the OECD's recommendations published as part of its Base Erosion and Profit Shifting (BEPS) project. The key aspect of these new rules is likely to be the 'fixed ratio' limit, which provides that a UK group's tax deductible interest expense for a period of account should be limited to 30 per cent of its EBITDA (calculated after taking into account certain tax-related adjustments) for that period. Currently, the UK also has a worldwide debt cap regime that limits interest deductibility when the UK portion of a group is deemed overleveraged when compared with the rest of the group, though it is anticipated that these rules will be repealed and replaced with a similar regime under the new BEPS changes. Inevitably, deductibility of interest will be looked at and modelled by accountants in the context of an acquisition financing.

While interest in payment-in-kind (PIK) instruments fluctuates, and is currently less seen partly as a result of spillover effects of US leveraged lending guidelines, it is also worth noting that PIK interest is, in principle and in common with cash paid interest, deductible on an accruals basis for UK corporation tax purposes. Notably, UK withholding tax only applies where interest is paid (in cash, or through the issue of PIK securities representing the interest due) – the rolling-up of PIK interest with no corresponding payment should, in principle, not trigger UK withholding tax.

The provision of acquisition finance and subsequent transfers of debt in the secondary market are typically exempt from UK stamp duty. In this context, there is a general stamp duty exemption for debt (assuming that the debt is not considered to have equity-like characteristics), known as the 'loan capital' exemption.

III SECURITY AND GUARANTEES

Upstream, cross-stream and downstream guarantee and security packages are widely used in leveraged and acquisition financings involving England and Wales.

As an initial matter, guarantees are readily available from companies incorporated in England and Wales (for ease of reference, referred to in this chapter as English companies), subject to a number of caveats that as a practical matter are usually able to be dealt with in the typical finance transaction. These include the following:

a the guarantor must have the capacity to give the guarantee under its constitutional documents, and in addition each director of an English company must act in the manner that he or she considers, in good faith, would be most likely to promote the success of the company for the benefit of its shareholders as a whole[4] (i.e., there normally must be a corporate benefit). English case law does, however, support the premise that a shareholders' resolution may ratify transactions that are outside the scope of the directors' authority, so it is common to require such a resolution in the case of upstream or cross-stream guarantees given by an English company where the benefit to that company may be unclear;

b English law guarantees are unenforceable unless evidenced in writing and signed by or on behalf of the guarantor;[5] in addition, a guarantee under English law is a contract, so there must either be consideration or the guarantee must be signed as a deed (the enforceability of a deed does not require consideration, unlike an ordinary contract);

c generally speaking, no English public limited company or English incorporated subsidiary of the public limited company may give financial assistance directly or indirectly for the purpose of the acquisition of shares in the public limited company or, in the case of a public limited company, the acquisition of shares in its private limited company holding company; otherwise, the financial assistance restriction on English private companies with its 'whitewash' exception was eliminated in 2008 and is no longer a concern;[6] and

d if the giving of a guarantee requires the making of a provision by the guarantor at the time of the giving of the guarantee, it could be deemed a distribution that would need to be limited to distributable reserves of the guarantor. It is not often the case that a provision is required at the time an acquisition financing is made.

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4 Section 172 of the Companies Act 2006. The Act also sets out factors that a director must consider in fulfilling that duty, including 'the likely consequences of the decision in the long term […] the interests of employees […] the need to foster […] business relationships with suppliers, customers and others […] the impact of the company's operations on the community and the environment […] the desirability of the company maintaining a reputation for high standards of business conduct [and] the need to act fairly among' shareholders. These additional factors are relatively new under English company law. Directors may also owe a duty to creditors if the company is nearing insolvency, and the Section 172 duties of directors are expressly subject to those other duties in that circumstance.

5 Section 4 of the Statute of Frauds 1677.

6 As a matter of practice, a leveraged acquisition of a public limited company will typically be followed by a reregistration of the company as a private limited company, after which any required financial assistance would be given.

English law also distinguishes between guarantees and indemnities. A guarantee is a secondary obligation that cannot be more robust than the primary obligation guaranteed, so the guarantor may rely on any defence available to the person or entity whose obligations are guaranteed, while indemnities are primary obligations and can be enforceable even when the obligation guaranteed is not; a well-drafted 'guarantee' agreement will include both, and that distinction can be ignored as a practical matter.

In terms of security, England and Wales is a creditor-friendly jurisdiction that allows creditors to obtain meaningful and comprehensive security, usually at a reasonable cost.[7] However, the details are complex, because security in this jurisdiction is a creature of common law with a degree of statutory support, and takes multiple forms. The forms relevant to modern leveraged finance are a mortgage through transfer of title; a pledge through transfer of possession; a charge (an equitable appropriation – without any transfer of possession – of an asset to meet a debt); and a possessory 'lien', which enables the secured party to retain possession until paid, but not to sell the asset in question unless the lien is a banker's lien – and this category of security also causes endless confusion in conversations between solicitors, on the one hand, and US lawyers and the high-yield market, on the other, which understand 'lien' to mean 'security interest' generally.

Further complicating matters, which of these different kinds of security is appropriate for a given asset depends on the nature of the asset – for instance, a pledge or lien can only be given over an asset over which possession may be taken (i.e., physical assets; security over intangible assets that can only be taken through a mortgage or charge, etc). Notably, and by way of contrast to certain other jurisdictions, English law does allow grants of security over future property so the security automatically attaches when the debtor acquires an interest in the asset in question.

A mortgage or charge can be legal or equitable; the principal practical difference between legal and equitable is whether a *bona fide* purchaser for value without notice takes precedence and, in the case of a legal dispute in relation to a contract right mortgaged or charged, whether the secured party may need to join the pledgor in the legal dispute.

Third-party security – a grant of security by an entity that is not otherwise a guarantor or borrower – is also a workable and common construct under English law, particularly for security granted by a holding company in shares of or loans to a subsidiary where the holding company is not otherwise part of the financing.[8]

Where security is to be granted to a class of creditors that changes over time – for example, lenders under a syndicated loan agreement – it is well-established practice in England to grant the security in favour of a security trustee, who holds the security on trust for that changing group of creditors, eliminating the need to deal with transfers of security when interests in the loan are transferred.

Finally, if an English company grants certain kinds of security, whether over assets in the United Kingdom or abroad and whether under an English law security document or under a foreign law security document, as a general rule a certified copy of the instrument granting the charge (security) together with a duly completed 'statement of particulars' must

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7 Security granted by partnerships presents particular issues that are not further addressed here.

8 But cf. discussion below regarding the power of certain floating charge holders to appoint an administrator, which will not be available in the case of third-party security in the absence of such a floating charge.

be presented for registration with the Registrar of Companies within 21 days of creation, otherwise the charge will be void against any liquidator, administrator or other creditor of the security grantor.[9] While certain exceptions apply,[10] this requirement applies to most security granted by an English company in a typical acquisition or leveraged financing.

Notwithstanding all this apparent complexity, commercial lawyers in England and Wales have developed the 'all singing, all dancing' debenture, which grants appropriate forms of fixed and floating security over virtually all assets of a security grantor; as such, obtaining the right security in practice can usually be done through the execution of one agreement, and at reasonable cost, absent unusual circumstances.

English law provides that security, and in some cases guarantees, may be avoided if they represent transactions at an undervalue[11] or a preference.[12] The incidence of challenge on the basis of a transaction at an undervalue is significantly less than the US fraudulent conveyance or transfer principles that have a superficial similarity, largely because safe harbours apply in the United Kingdom where the transaction is entered into by the company in good faith and for the purpose of carrying on its business, and at the time it did so there were reasonable grounds to believe that the transaction would benefit the company (and in any event is not being entered into for the purpose of putting assets beyond the reach of a creditor or prejudicing creditors). In addition, preference claims in the United Kingdom require a degree of desire to prefer (i.e., intent) on the part of the guarantor or security grantor that has made this area of attack of almost no market concern to the structuring of a typical acquisition or leveraged financing.

A floating charge may also be set aside, except to the extent of any value to the company given at the same time or after the grant of the floating charge, if it is granted within 12 months of insolvency unless the company was not unable to pay its debts[13] at the time of the grant or as a consequence of the transaction. This period is extended to two years (and without the benefit of that solvency exception) if granted to a connected person.[14]

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9 Section 859H(2) of the Companies Act 2006.

10 A notable exemption is where the security is over financial collateral and qualifies as a 'security financial collateral arrangement' under the Financial Collateral Arrangements (No. 2) Regulations 2003 (as amended), in which case the Regulations confer a number of benefits on the collateral taker, including an exemption from registering the security. The collateral taker also benefits from the right to 'appropriate' the financial collateral in an enforcement scenario. Moreover, in an insolvency situation, benefits to the collateral taker under the Regulations include removing some of the restrictions on enforcing security, disapplying insolvency provisions relating to the order of payment of creditors and prohibiting avoidance by a liquidator or administrator of the financial collateral arrangement in certain situations.

11 Sections 238 and 423 of the Insolvency Act 1986.

12 Section 239 of the Insolvency Act 1986.

13 Within the meaning of Section 123 of the Insolvency Act 1986.

14 Section 245 of the Insolvency Act 1986. Note that under Section 426 of the Insolvency Act 1986, a court with insolvency jurisdiction in another jurisdiction may seek assistance from a court that has insolvency jurisdiction in the United Kingdom, and this may give the UK court discretion to apply either English or the applicable foreign law in certain circumstances, which could add other grounds for challenge.

While the distinction between a fixed and floating charge has consequences under applicable statutes, there is no statutory definition of a fixed or floating charge, and the distinction has been drawn in case law. The leading decision in the area[15] stands for the principle that it is possible a purported fixed charge may be recharacterised as a floating charge if the chargor retains too much ability to deal in the asset charged. The distinction is not always easy to draw but, absent unusual circumstances, security in assets that are changing over time (such as inventory) will be floating.

A floating charge which, together with any fixed charges in favour of the holder of the floating charge, relates to the whole or substantially the whole of the chargor's property and is either designated expressly as a qualifying floating charge by reference to paragraph 14 of Schedule B1 of the Insolvency Act 1986 or purports to give the holder the power to appoint an administrator or administrative receiver, will enable the holder to appoint the administrator in the event of an administration. This is considered a useful power by secured parties and features in most debentures.

IV PRIORITY OF CLAIMS

Floating charges, when compared to a fixed charge, are relatively vulnerable to other claims. A subsequent fixed charge taken without notice is prior to a floating charge, and there are certain categories of claims that are prior to floating but not fixed charges.[16] The main categories are as follows:

a expenses of winding up or the administration of the chargor (including the remuneration of the liquidator or administrator but excluding certain litigation costs), to the extent the assets of the chargor are insufficient to pay general creditors;

b a 'prescribed part' of the floating charge assets, which varies but is currently capped at £600,000, is made available for unsecured creditors;

c certain pension claims (usually relatively small in amount – certain employee contributions deducted but not yet paid; 12 months of employer contributions to a contracted-out scheme, subject to various limitations); and

d certain unpaid wage and accrued holiday entitlements of employees and similar amounts.

When the above are being considered in relation to a corporate group, they are determined on a company-by-company basis, although there are limited categories of liabilities such as pensions and tax that can cut across corporate entities (i.e., pierce the corporate veil).

Unfunded pension liabilities in the United Kingdom are normally not priority claims and are not prior to valid fixed or floating charges. However, change of control transactions can trigger significant rights to require payments by the trustees of the pension liabilities, so it is

15 *National Westminster Bank plc v. Spectrum Plus Limited and others* [2005] UKHL 41.

16 Certain exceptions also apply for charges that constitute a 'security financial collateral arrangement' under the Financial Collateral Arrangements (No. 2) Regulations 2003 (as amended), also discussed in footnote 10.

not uncommon (where the credit quality of the unsecured undertaking to pay is reduced in the transaction) for a negotiation to ensue with the pension trustees that may result in a consensual granting of security for those liabilities, rather than immediate payment, as negotiated.

In the context of a corporate group, entities other than the employer itself may also have liability under the Pensions Regulator's ability to give financial support directions or contribution notices under the Pensions Act 2004.[17] A 2013 Supreme Court case[18] is of relief to holders of floating charges, because it overruled a recent line of precedents that had held such directions or notices, if given after the initiation of an insolvency proceeding, to be a priority claim.

English law also has a concept of 'perfecting' a security interest that is different from the US equivalent, in that a lack of perfection does not mean the security is invalid in a bankruptcy. Instead, English perfection relates to priority over certain potential competing interests – for instance, an assignment of a receivable or a bank account (which analytically is similar under English law) is perfected by giving notice of the assignment to the account debtor, and until this takes place a *bona fide* purchaser for value (which may include a subsequent security taker) may achieve priority, and rights of set off in favour of the account debtor may continue to accrue.

Contractual subordination is much used in English law finance documentation, particularly intercreditor agreements, and there is general agreement that – as a matter of English law – it should be enforceable as between the contracting parties. Surprisingly, the case law support for this is not as developed as one might expect; while recent case law is clearly supportive,[19] the waters were initially muddied by the 1975 *British Eagle* case,[20] in which the rights of creditors who had not agreed were sought to be affected by a clearing agency netting arrangement (and accordingly the case was distinguishable on its facts). In addition, language is normally included in well-drafted intercreditor agreements to require turn over in the event of mandatory insolvency set off (which can apply in some circumstances)[21] or another mandatory distribution of assets contrary to the agreement that results in a recovery to a subordinated creditor.

V JURISDICTION

Expressly selecting English law to govern a commercial contract such as a loan or credit agreement is straightforward – the EU Rome I Regulation[22] applies to give effect to the

17 This power to impose liabilities on other group companies is not limited to other English companies, and accordingly can extend to legal persons in other jurisdictions.

18 *Re Nortel Companies and Re Lehman Companies* [2013] UK SC 52.

19 See, e.g., *Squires & Ors (Liquidators of SSSL Realisations (2002) Limited) v. AIG Europe (UK) Ltd and Anor* [2006] EWCA Civ 7; *Re Maxwell Communications Corporation* [1993] 1 WLR 1402.

20 *British Eagle International Air Lines v. Compagnie Nationale Air France* [1975] 1 WLR 758.

21 See, e.g., *National Westminster Bank Ltd v. Halesowen Presswork & Assemblies Ltd* [1972] AC 785.

22 Regulation (EC) 593/2008 on the Law Applicable to Contractual Obligations.

parties' choice (without any requirements for, e.g., connection to England), but there are certain important exceptions and, where these are applicable, further thought must be given. The main ones relate to:

a the existence, due authorisation, capacity, execution of agreements by and winding-up of legal entities;
b whether an agent can bind a principal;
c formation of trusts and the relationship between the parties to the trust (this includes indenture trusts);
d obligations from dealings prior to the conclusion of an agreement; and
e choice of forum and arbitration agreements.[23]

In addition, Rome I does not override mandatory provisions of public policy of individual countries.

The subsequent Rome II Regulation[24] has extended a similar regime to allow parties to choose the law applicable to non-contractual obligations. This choice may be made either in an agreement after the event giving rise to the damage occurred, or also 'where all the parties are pursuing a commercial activity [...] by an agreement freely negotiated before the event giving rise to the damage occurred'. This regime is subject to exceptions that are largely (but not entirely) similar to those in Rome I. Generally and broadly speaking, a contractual submission to the jurisdiction of an English court of competent jurisdiction in connection with financing documentation will be valid, subject to a variety of exceptions that are not seen as problematic by the markets but that can be in particular circumstances. The precise nature of the exceptions is dependent, *inter alia*, on the domicile of the person submitting to that jurisdiction[25] and whether another forum is more appropriate, and whether other proceedings are already pending or the issue has been determined in other proceedings.

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23 Arbitration clauses are normally only entered into in acquisition financings where the borrower or target is organised in a jurisdiction that enforces arbitral awards but not, for example, English court judgments. Examples of such countries include Russia and a number of the other countries that were formerly part of the Soviet Union.

24 Regulation (EC) 864/2007 on the Law Applicable to Non-Contractual Obligations.

25 This in part arises from the complex web of law in this area, the primary bodies of law in the UK being Regulation (EC) No. 44/2001 of 22 December 2000 on the Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters and the Civil Jurisdiction and Judgments Act 1982 applying the 1968 Brussels Convention and the 1988 Lugano Convention.

There is currently some market debate as to the extent to which a French Court of Cassation case (Decision 11-26.022 (26 September 2012)), which held invalid – on the basis of certain principles of French or Luxembourg contract law (which is not clear in the case) – a consent to jurisdiction clause in which one party agreed to exclusive jurisdiction but the other party could bring suit in that or other jurisdictions (i.e., it was asymmetrical in application), raises an issue in the United Kingdom for the normal asymmetrical consents to jurisdiction used in European leveraged finance (exclusive for the borrower and non-exclusive for the lenders), because the Court of Cassation purported to make its decision under the Regulation, which also has the force of law in the United Kingdom. It is the view of the authors of this chapter that the

English courts do not automatically give leave to serve process on parties located outside the United Kingdom even where there is a contractual consent by that party to jurisdiction, so it is considered good practice to require foreign contractual counterparties to appoint an agent for service of process in England and Wales where appropriate.

The UK referendum on EU membership referred to above may have an effect on whether the EU regulations described above continue to apply indefinitely. EU Regulations naturally have direct force of law in Member States (subject to certain exceptions not relevant here) without any domestic legislation being required, in contrast with EU Directives, which must be implemented domestically. This means that, theoretically, if the UK ceases to be a Member State of the European Union and does no legislative planning, the then-existing European laws under the Regulations will cease to apply in the UK but the then-existing European laws following Directives will continue to apply because they have been given effect by locally enacted domestic laws.

It seems unlikely that no planning will occur, and it is even possible that no Brexit will ever take place since the referendum was technically advisory in its legal status. There are, however, some preliminary observations that can be made about Brexit without any legislative changes:

a recognition and enforcement of foreign judgments in commercial cases will still 'work' under English law more or less as before, just the legal framework and detail will change in relation to judgments from EU/European Free Trade Association countries;[26] it is helpful in that respect that many of the main EU countries are party to the Brussels Convention 1968 (further depending on the country in which enforcement is sought, the Brussels Convention 1968 likely gives comfort that English judgments in those countries will continue to be generally enforceable subject to typical caveats); and

b English common law is well developed in relation to recognition of a contractual choice of law for a contract involving loans, bonds and other commercial matters, so from an English law viewpoint the differences between the choice of law regime under the regulations and the common law should have little or no practical effect on finance documents.

laws of England as currently in effect do not follow that French case (and there is now case law in another jurisdiction refusing to follow that case), but it should be recognised when dealing with French parties that if a dispute is first brought in France, the French court may disregard any consent to jurisdiction clause that is asymmetrical.

26 Givers of legal opinions will have the unenviable task of determining which apply of (1) the Brussels Convention 1968 (enacted into English law under the Civil Jurisdictions and Judgments Act 1982), and applying to a variety of current and past European Union/European Free Trade Association countries, (2) the Administration of Justice Act 1920, applying roughly to the Commonwealth countries but notably excluding countries such as Australia, Bangladesh, Canada, Gibraltar, Hong Kong, India and South Africa, (3) the Foreign Judgments (Reciprocal Enforcement) Act 1933, which applies to a variety of countries including India, Pakistan, Australia, the Australian Capital Territory, the Federal Courts of Canada and the Canadian Provinces (except Quebec) and (4) the common law regime.

VI ACQUISITIONS OF PUBLIC COMPANIES

The financing of acquisitions of public companies in the United Kingdom presents additional issues for financiers beyond those issues usual for an acquisition financing. Most of these arise from the fact that, if the target is a UK, Jersey, Guernsey or Isle of Man-incorporated public limited company, the acquisition will be subject to the City Code on Takeovers and Mergers (Code), which is administered by the Panel on Takeovers and Mergers (the Panel). The Panel was established in 1968 without a statutory underpinning, and yet functioned effectively for many years that way; it now has various regulatory underpinnings from the Companies Act 2006 and the European Directive on Takeover Bids.

The main Panel-related issues for such a financing are:

a the requirement that the bidder have 'certain funds', from the time of announcement of a firm intention to make an offer, which affects the form and permitted conditionality of the financing;

b Panel requirements that the terms of the offer financing be publicly disclosed – including commercially sensitive fee and flex terms;[27] and

c the Panel imposes a strict confidentiality and equality of information regime that narrowly limits the number of persons (including potential financing banks) who may be told of an offer before its announcement, but also affects how syndication can be carried out after announcement and, depending on the circumstances, the scope of diligence that can be done (including in preparation for a high-yield bond offering).

In addition, for offers that are effected by means of a tender offer,[28] lenders must get comfortable with an interplay between the availability of the statutory minority shareholder squeeze-out regime (at 90 per cent acceptances measured across the shares for which the offer is made rather than measured across the issued share capital)[29] and the practical

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27 The Panel has (on application) allowed a delay in disclosing flex terms until the offer document is posted to shareholders (at the latest 28 days after the announcement of the firm intention to make an offer), and also that the terms may be omitted from the offer document if they can no longer be exercised at that time. Given the difficulty of syndicating an undrawn financing in 28 days, this limited window does not often eliminate the issue for the borrower or its financiers.

28 An offer effected through a scheme of arrangement under Part 26 of the Companies Act 2006 does not present these issues because, once the requirements for it are met (which include a vote of a majority in number and 75 per cent in value of the shareholders (or class of shareholders, depending on the specifics) present and voting either in person or by proxy (see Section 899 of the Companies Act 2006), and a court hearing as to fairness and certain other matters), no further approvals are required to squeeze out any dissenting shareholders, to delist the target and to reregister it as a private limited company (so as to enable it to give financial assistance). A scheme also has certain stamp tax and other advantages (including in some cases exemptions from registration under Section 3(a)(10) of the US Securities Act of 1933 for shares issued in the scheme) that usually make this the preferred method unless the target is hostile, there is a significant risk of competing offers or there are other reasons for the speed of execution being important (the scheme timetable can be longer than an offer timetable).

29 Section 979 of the Companies Act 2006.

need to allow the bid to become unconditional as to acceptances at a level lower than this.[30] Lenders usually get comfortable with the risk profile for closing at a 75 per cent or above level of acceptances (measured in this case at 75 per cent of the fully diluted issued voting share capital – the level at which control of a special resolution of shareholders is guaranteed), for a number of corporate governance reasons under the Companies Act 2006 and because a 75 per cent shareholder can take the target private at this level of shareholder control both in terms of delisting it and reregistering it as a private limited company so as to enable the target to give financial assistance for the financing. There are additional risks in closing below this level.[31]

The certain funds requirement arises from a Panel requirement that an offer, when announced (and also the subsequent offer document), must include a confirmation by the bidder's financial adviser – or by another appropriate third party – regarding the bidder's available resources. Because the financial adviser might be required to fund the offer if the resources prove to be unavailable, fundable commitment[32] or long-form finance documentation is required at this stage that include only conditions to funding during the offer period that are completely within the bidder's control. The sole exception to this is that financial advisers will normally also permit a condition for illegality or invalidity of the financing documents.

The financiers are able to obtain some indirect comfort from the detailed terms of the offer itself – which will include conditions such as the absence of material adverse change – but the Code provides that the bidder (and so, indirectly, also the lenders) may rely on an unsatisfied condition only if the Panel consents to the bidder withdrawing the

30 It is rare for an offer to achieve 90 per cent acceptances without first being declared or otherwise becoming unconditional as to acceptances at a lower level – e.g., some institutional investors are not permitted to (or as a matter of practice do not) accept offers until the offer has become unconditional in this way. There are also circumstances in which a bidder can trigger an affirmative obligation to make an offer – known as a 'Rule 9 Mandatory Offer' after the Code provision requiring it – but such an offer presents additional risks for a financier, is rarely debt financed and is not otherwise discussed here.

31 There are also a variety of minority challenge rights that, although they are rarely encountered in the typical take-private financing for an offer, they nonetheless do exist; for example, a holder of 5 per cent or more of the target shares (among certain others) can apply to court to challenge the reregistration of the target as a private company. In addition, any shareholder may generally challenge corporate actions on the basis that the target's affairs are being conducted in a manner that is unfairly prejudicial to the interests of shareholders generally or to a class of them.

There is little case law, which is comforting because it means challenges are rare, but it also means there are few guidelines from which to assess the likelihood of success in a given circumstance. It is widely observed that the greater the majority of shareholders accepting an offer, the less the likelihood that a court would intervene. Optimally, an offer would achieve a level of acceptances that permits squeeze-out so that relevant corporate actions can be taken without this concern (although theoretically the squeeze-out too could be challenged on these bases, there is something of a consensus that this kind of challenge for a cash bid could only succeed in unusual circumstances).

32 In some cases financiers are comfortable with a commitment letter and a fundable interim loan agreement to bridge the period until long-form documents can be negotiated and agreed.

offer on this basis. However, the Panel's history in this area is not encouraging to bidders or lenders seeking comfort from those conditions. In practice, even if a condition has not been satisfied by its terms, the Panel will only give such consent where the circumstances underlying the failure of the condition are of material significance to the bidder in the context of the offer.

This feature is softened by two exceptions – the bidder may always rely on:

a the condition as to level of acceptances (and, as noted, in practice the 90 per cent threshold most offers start with is rarely achieved without it being waived, so the bidder can always consider the other conditions in deciding whether to waive); and

b the condition regarding absence of referral for UK or European competition authority review.

The Panel interprets its confidentiality rules and 'equality of information' rules broadly and, prior to announcement of a bid, a bidder normally must consult the Panel before disclosing the possibility of the offer beyond a very limited number of parties, which is usually no more than six entities outside of the bidder's advisers – as such, this limit of six entities applies to sources of debt and equity finance (where they are not also acting in an advisory capacity), target shareholders, bidder shareholders, etc. This can sometimes make the formation prior to announcement of a (small) club of financing banks challenging.

Following announcement, the rules on confidential information are applied such that special steps must be taken to ensure potential lenders who will have access to non-public information (e.g., projections) either do not hold equity in the target – which can be difficult for entities with trading desks – or have appropriate information barriers.[33] Finally, the equality of information rules can adversely affect the willingness of a target to allow due diligence, given that a competing bidder will often have a right to the same information.

VII OUTLOOK

It has been reported by S&P Capital IQ that European leveraged loan and bond new issue volumes were each down in the first six months of 2016 from the comparable period in 2015. This can be attributed to a number of factors, such as international (and in particular emerging markets) ramifications from an increase in interest rates by the US Federal Reserve in the second half of 2015, a decrease in LBO merger and acquisition activity, and in the UK – more specifically, uncertainty in the run-up to the June referendum. The Brexit vote led to a period of high volatility but at the time of writing the markets have

33 This requirement is embodied in confidentiality language agreed between the Loan Market Association (LMA) and the Panel, and is published in the LMA form Confidentiality and Front Running Letter for Primary Syndication. However, there is an additional due diligence requirement on the bidder's financial adviser that can cause issues for any kind of wide syndication – particularly exacerbated where 'click through' web-based confidentiality agreements are sought to be used, as would be the norm in some cases outside the UK offer financing context (e.g., in a US term loan syndication). See Panel Practice Statement 25, Debt Syndication During Offer Periods.

largely recovered to the pre-vote levels. Inevitably, a period of uncertainty will follow the Brexit vote that may affect the UK in ways difficult to predict. However, fundamentals for leveraged finance remain encouraging including in terms of the amounts of uninvested funds being raised by direct lender funds, CLOs and other institutional investors, the 'dry powder' of the European private equity community and the refinancing needs visible in the market, particularly for 2017.

Second-lien, covenant-lite and unitranche financings are giving borrowers and investors on both sides of the Atlantic more borrowing and investment choices and opportunities. The impact of financial regulations (e.g., Dodd-Frank, Basel III) on leveraged lenders and lending activities more generally is something that continues to affect the market in a variety of ways,[34] as will the effect of expected further rises in interest rates in the United States.

Any of these factors seem certain to affect the current trends we are seeing, although in ways that are difficult to predict. The sanctions landscape must also be monitored carefully in the current geopolitical climate.

34 Notably, the US leveraged lending guidelines are having a clear effect in Europe, albeit of uneven application due to its uneven coverage of players and kinds of financings.

Chapter 9

FINLAND

Timo Lehtimäki and Maria Pajuniemi[1]

I OVERVIEW

Financing transactions in Finland are generally split into two separate markets. International bank syndicates provide the financing for typically English or US law-governed cross-border transactions, whereas domestic, smaller-scale transactions are usually financed by local Finnish or Nordic banks with agreements often governed by Finnish law.

The global economic situation and the reduced number of M&A deals in the Nordic region have resulted in some patchiness in the area of financing as well. There have, however, been a number of interesting big-ticket deals such as the €1.93 billion refinancing of the Caruna Group (former Fortum grid network) consisting of senior facilities and a €10 billion multi-currency bond programme. The market has also witnessed a notable rise in receivables-based financing utilising both trade receivables and consumer receivables, as well as securitisation transactions, such as the multiple auto loan hire-purchase contracts securitisations by Santander.

II REGULATORY AND TAX MATTERS

i Licensing and regulatory issues; anti-money laundering requirements

The financing of transactions with a Finnish element by lenders, investors or security agents is not as such a regulated business in Finland.

As an EU Member State, Finland has implemented the third Anti-Money Laundering Directive (2005/60/EC). As a result, Finnish credit institutions and investment funds, *inter alia*, are subject to certain risk management and know your customer requirements, as well as notification requirements in respect of suspect activities. In addition, the sanctions imposed on Russia set further requirements for the compliance functions of market participants while the Russian counter-sanctions affect exports.

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ii Overview of tax matters

The success of M&A transactions is highly dependent on an appropriate acquisition and financing structure. Using maximum leverage in an acquisition where the return on assets exceeds the interest expenses normally leads to a substantially higher return on equity. For this reason, debt pushdown structures are also frequently used in Finland.

A typical structure would be for a foreign acquirer to establish a Finnish special purpose vehicle (SPV), and that acquisition vehicle would borrow from both its shareholders and third-party lenders for the purpose of financing the acquisition of the target. Third-party funding is normally necessary due to certain restrictions on the tax deductibility of interest expenses on shareholder or other intra-group loans.

The goal is to set off the interest expenses of the SPV against the target's income by using tax consolidation in the form of the Finnish group contribution scheme or by merging the target into the SPV. In principle, following the acquisition, the target's profits may, from a Finnish tax perspective, be offset against the SPV's losses (interest expenses) under the Finnish group contribution rules. Alternatively, the SPV and the target can merge following the acquisition, whereby the operating cash flow of the target may be used for interest payments and repayments of the funding received by the SPV.

Subject to the interest limitations rules, the interest expenses incurred by the SPV are otherwise generally (and fully) tax-deductible. Finnish tax laws do not, as such, contain any specific thin capitalisation rules or rules according to which, for example, interest payments on hybrid loans could be reclassified as (non-deductible) dividend payments for tax purposes.

Interest payments made by a Finnish company to a non-resident company are only rarely subject to withholding tax in Finland (and would, in reality, require a reclassification of the loan instrument as equity). In addition, the domicile of the recipient of the interest payment is generally irrelevant for tax purposes, and interest payments made to recipients located in tax havens are equally exempted from withholding tax. The fact that a loan is widely syndicated (including mezzanine) or subordinated, or that the loan is a profit participating loan, should in normal circumstances not affect the tax deductibility of interest payments.

While the need to obtain debt financing for acquisitions is well understood, Finland has, following the pattern of most other jurisdictions, recently introduced limitations on interest deductibility.

The new Finnish interest limitation regime is applied if the net interest expenses paid by a company on intra-group loans (i.e., related-party interest) exceed €500,000 annually. The amount of deductible net interest expenses is, at the outset, limited to 25 per cent of tax EBITDA (earnings before interest, tax, depreciation and amortisation) of a company (adjusted taxable income based on Finnish tax principles); however, under a specific safe harbour rule, a company whose equity-to-assets ratio is equal to or larger than the corresponding ratio of the group is exempt from the limitation regime.

In order to tackle circumvention, interest payments to third parties may also be deemed as related party interest in certain cases and thus subject to the limitations. This would include interest paid in back-to-back arrangements or on third-party loans that have been secured by a related-party receivable.

III SECURITY AND GUARANTEES

i Establishing a security interest

The most common types of security in Finland to secure bank or bond financing are share pledges, floating charges over qualifying moveable business assets, mortgages over real estate, and pledges over registered intellectual property rights, bank accounts and intra-group receivables. Pledges of trade receivables are also sometimes used. In acquisition financing, acquisition claims are typically pledged. It is also possible to mortgage certain moveables, such as registered aircraft, vessels and certain vehicles. The collateral use of other assets, such as insurance claims, is rare and complicated.

To establish a valid security interest under Finnish law, there must be a valid underlying debtor–creditor relationship that is being secured (a secured obligation), the pledgor (chargor) must expressly grant the security interest (typically in the form of a security agreement) and certain perfection measures must be taken.

The creation or enforcement of security is not, in itself, subject to tax or stamp duty, and no notarisation is required. Minor registration costs apply in respect of certain types of security.

Due perfection of security under Finnish law generally entails that the pledgor or chargor must be effectively deprived of its right to control, deal with or dispose of the security assets. Where the pledgor may remain in possession of, retain exclusive or shared control over, be entitled to operate or collect, invest and dispose of any income from the security assets, security is not generally deemed effective in relation to third parties. Such unperfected security interest is vulnerable of being set aside in the event of the insolvency of the pledgor and may, potentially, be declared void. This depends, however, on the type of security and, for instance, floating charges, real estate mortgages and pledges of registered intellectual property can be duly perfected while the pledgor remains in control of the assets.

Finnish law does not recognise, *inter alia*, English law-type charges over rights, title and interest in contractual arrangements (which are, from a Finnish law point of view, classified as pledges of the relevant underlying claims), or US-type security perfection by way of Uniform Commercial Code filings. The key features of the most commonly used types of security and the related perfection mechanics are described below.

Shares

Pledges over shares in wholly owned private limited liability companies are generally easy to create and enforce, and provide a good security of 100 per cent of the equity of the company in question. Therefore, they are almost invariably included in a standard security package. Shares in partially owned subsidiaries are also sometimes pledged; however, such security is naturally less valuable and more complicated to enforce due to minority shareholder rights. Shares in listed public limited liability companies can be pledged, but often only subsidiary shares are part of the security package.

A notice of the pledge to the company and entry of the pledge in the company's register of shares are required for perfection. In Finland, no stock transfer forms are used. If share certificates have been issued, possession and control by the pledgee of the original share certificates, duly endorsed in blank by the pledgor, are also required for due perfection. Where shares are issued in paperless book-entry form (as is the case in respect of listed Finnish companies and certain other companies), the pledge is perfected by registering it over the relevant book-entry account.

If not separately pledged, shares owned by pledgors will be covered by floating charges.

Floating charge

A Finnish law floating charge (sometimes also referred to as a 'business mortgage' or 'enterprise mortgage') creates a security interest over the qualifying moveable assets of the pledgor company.

A floating charge will, by operation of law, cover all the pledgor company's moveable assets insofar as any specific assets have not been separately pledged. A floating charge may, depending on the circumstances, exclude separately pledged bank accounts, shares, intellectual property rights, certain claims, trade receivables, intra-group receivables, etc. Assets capable of being subject to a mortgage (generally land and buildings thereon, certain vehicles, aircraft and vessels) are always outside the ambit of the floating charge (apart from certain vehicles) even when they are not subject to a mortgage. Consequently, a floating charge will, typically, cover inventories (finished and semi-finished goods), raw materials, trade receivables, tools and equipment, and securities, cash and bank accounts (to the extent not specifically pledged).

A floating charge is created by the pledgor company issuing one or more floating charge promissory notes of the notional denomination as to be agreed with the secured lender. The promissory notes are then registered against the chargor company in a public register. After registration, the promissory notes are, legally speaking, pledged under a pledge agreement for the benefit of the lender and delivered to the lender in original.

Under law, the chargor company retains the right to dispose of the assets covered by the floating charge in the ordinary course of business. A Finnish law floating charge will not crystallise until enforcement.

Upon enforcement of a floating charge in bankruptcy, only 50 per cent of the net proceeds of the assets covered by the floating charge, after administration and sales costs have been satisfied, will be applied for the benefit of the floating charge holders. The balance (50 per cent) will be applied to satisfy the unsecured creditors (holders of floating charges will stand *pari passu* with unsecured creditors for satisfaction of their excess claims from the balance of the proceeds). If a floating charge is enforced in pre-insolvency enforcement proceedings before the formal bankruptcy of the debtor company, the floating charge holder has priority for the entire amount of the net proceeds covered by the floating charge. However, in reality such enforcement is rare, as the pending enforcement will in practice invariably lead to the bankruptcy or administration of the debtor company. In company administration (analogous to US Chapter 11 proceedings), a moratorium will apply.

A floating charge is always enforced through a bankruptcy liquidator or administrator or public enforcement authorities, whereas a pledgee of specific assets is generally able to enforce the pledge independently.

Real estate mortgage

A real estate mortgage can be registered against freehold and certain leasehold properties and buildings thereon.

A real estate mortgage under Finnish law is considered to be a good quality security, and it does not suffer from the 50 per cent handicap as described above in respect of a floating charge. To create a real estate mortgage, mortgage certificates of a notional denomination are registered against the real estate and, similar to floating charges, delivered in original to the mortgagee to perfect the mortgage.

Registered intellectual property rights

For a pledge over intellectual property rights to be duly perfected, the pledge must be registered in a public register on an intellectual property right specific basis.

A pledge over Finnish patents and trademarks is perfected by registering the pledge with the Finnish Patent and Registration Office or, in the case of European trademarks, registering the pledge with the Office for Harmonization in the Internal Market or, in the case of European patents, registering the pledge with the European Patent Office.

In Finland, for example, copyrights and other artistic product rights are not registered in a public register, and therefore cannot be effectively used as collateral.

However, if there is no separate pledge of intellectual property rights, they will be captured by the floating charge. The separate pledge must be registered prior to registering the floating charge, since a registered floating charge will prevent the subsequent registration of separate pledges. In principle, intellectual property rights that cannot be registered, and hence separately pledged, are also covered by the floating charge.

Receivables

Pledges over receivables (including, *inter alia*, intra-group and trade receivables and all types of claims) are duly perfected under Finnish law by notifying the underlying debtor of the pledge and instructing the underlying debtor upon the pledging of the receivable to make any payments under the receivable to the pledgee only. For example, if the underlying debtors are notified on a deferred basis upon an event of default, the pledge will be subject to a hardening period (which it would not be if notice is given upfront when the pledge is created) and will not be valid in relation to third parties or an insolvency liquidator or administrator. In respect of future receivables, the receivables must also come into existence for the pledge to be effective. The exact requirements for due perfection of future receivables are subject to scholarly debate and give rise to certain practical issues, in particular in project financing.

The use of receivables as effective collateral is limited because of the stringent perfection requirements. However, intra-group receivables are often included in a comprehensive security package, but as a commercial matter, perfection is often delayed until an enforcement event. Trade receivables often remain outside a security package as many Finnish pledgor–debtors often hold, in practice, a highly negative view of perfecting pledges of trade receivables (i.e., notifying their customers that the receivables have been pledged and that payments must be made to a third-party financier). The perfection requirements may also sometimes result in an impediment to securitisation in Finland.

If not separately pledged, receivables and any payments received thereunder will be covered by a floating charge.

ii Guarantee limitations

Security obligations of and guarantees granted by Finnish guarantors are limited by the mandatory provisions of the Finnish Companies Act regulating financial assistance, unlawful distribution of a company's assets and corporate benefit.

Pursuant to the Companies Act, a Finnish limited liability company is prohibited from providing loans, guarantees, assets or security for the purpose of a third party acquiring shares in such company or in any of its direct or indirect parent companies.

There are no exact time limits; nor is there any clear-cut whitewash procedure to counter financial assistance. Post-acquisition restructurings where the target company is merged upstream are fairly common, despite the fact that there is scholarly debate on whether this serves to eliminate concerns of financial assistance. No court precedents are available on this matter. Typically, appropriate limitation language is included in guarantees and security agreements. In addition, a failure to properly segregate acquisition financing from other financing runs the risk of contaminating the entire facility notwithstanding any limitation language. Hence, tranching is often used in acquisition financing to enable target companies to effectively guarantee non-acquisition tranches of the facilities.

Under the Finnish rules on unlawful distribution of a company's assets, any act that diminishes the company's assets or increases its debts without a business rationale may constitute unlawful distribution of assets. The granting of guarantees or security, depending on the circumstances, may thus be considered as an unlawful distribution of company's assets, for instance, if a Finnish company, on the date of resolving to grant a guarantee or security, is aware or ought to have been aware that it is likely that the guarantee or security will be enforced.

The Companies Act also requires that when a company enters into a financing, or indeed any, transaction, it receives adequate corporate benefit from the transaction. Conversely, no guarantee or security may be granted by a company unless doing so is in the company's own commercial interest and confers corporate benefit taking into account all relevant benefits (including indirect benefits and goodwill) and risks to the company. Accordingly, the concept of unlawful distribution of a company's assets is much entwined with the concept of corporate benefit, albeit they are two separate issues.

While the financial assistance limitation is only applicable to upstream guarantees, the corporate benefit requirement and the prohibition on unlawful distribution, in principle, apply in up, down and cross-stream relations. All benefits derived from, and risks caused by, the transaction are to be considered. Indirect benefits such as goodwill, may also factor into the assessment.

The prevailing debate over the exact meaning of the requirements has resulted in varied practices regarding guarantee limitations. Sometimes the guarantee limitation is one of the toughest issues in negotiating financing transactions between Finnish counsel.

iii Role of security agents

Finnish law does not recognise the concept of trust; therefore, a security agent structure in respect of Finnish law-governed collateral is generally employed in syndicated financing transactions.

There is some uncertainty under Finnish law as to whether security can validly be granted in favour of an agent alone and not in favour of the pledgees. In Finland, the market practice is to grant the security to the secured creditors, who are then represented by an agent who can enter into a security agreement for and on behalf of the pledgees based on a power of attorney or a mandate of agency. It follows that Finnish security agreements are usually executed by the security agent as the agent acting for and on behalf of the secured parties.

iv Revocation

Finnish law recognises several grounds for revocation of transactions, including collateral, in a bankruptcy or company administration environment. The key grounds are briefly described below.

Under the general rule, any act or arrangement undertaken within a critical period of five years (or with no time limits, where a related entity is the counterparty) may be set aside provided that the transaction favours a creditor over the others, or has decreased the debtor's assets or increased the debtor's debts to the detriment of the (other) creditors. In addition, it is required that the debtor was insolvent at the time of the transaction, or became insolvent as a result thereof, and that the act or arrangement is deemed inappropriate.

In addition, a repayment of debt by the debtor within a critical time of three months (or two years, where a related entity is the counterparty) may also be set aside, provided that the payment was effected through the use of unusual means of payment, prematurely or for an amount constituting a substantial part of the assets of the debtor, unless the payment is made in the ordinary course of the debtor's business.

A security interest granted by the debtor within a critical time period of three months (or two years, where a related entity is the counterparty) may also be set aside where the security interest had not been agreed upon when the debt was incurred, or where the requisite measures for perfecting the security interest were not taken without any undue delay after the debt was incurred.

IV PRIORITY OF CLAIMS

Under Finnish law, the general rule is that similar creditors have an equal right to receive payment from the funds of the bankruptcy estate *pro rata* to their claims, unless otherwise provided by law.

Secured creditors holding a valid pledge over specific assets have priority to the relevant asset to satisfy their secured claim from the net proceeds of such assets and are generally able to enforce their right independently of bankruptcy proceedings.

Administrative expenses of the bankruptcy estate and debt incurred during insolvency proceedings enjoy the highest priority to the distribution of funds available to the estate. Taxes and employee benefits do not enjoy preferential treatment or protections and rank *pari passu* with other unsecured claims. Subordinated debt, such as capital loans (a special equity-like debt instrument governed by the Finnish Companies Act) or subordinated bonds in relation to other indebtedness of the debtor, rank ultimate after all creditors.

Contractual subordination is possible and frequently used. The Finnish Bankruptcy Act is relatively new and there is no case law available on the enforceability of English law Loan Market Association-compliant intercreditor agreements. While many legal scholars advocate the use of contractual subordination between creditors in syndicated debt financing, certain others suggest that an intercreditor agreement may not be binding in insolvency due to the operation of fundamental principles of Finnish law.

Structural subordination has no similar associated issues, and is commonly employed as the safer option when compared with purely contractual arrangements. US second-lien structures have appeared recently in the Finnish market. These have been well received as a modification of the more traditional way of structural subordination.

V JURISDICTION

i Consent to jurisdiction and choice of forum

In Finland, the parties to an agreement may freely choose between themselves the applicable law and competent forum.

The application of non-Finnish law by a Finnish court in a matter brought before it is subject to the applicable law not being contrary to mandatory fundamental principles of Finnish law and the application of such law not resulting in an outcome contrary to public policy.

Notwithstanding any choice of law clause, the application of Finnish procedural rules entails, *inter alia*, that punitive or exemplary damages are unenforceable, and a Finnish court may only award damages to the extent that they form compensation of actual losses and damage as proven by the claimant.

A feature of the Finnish civil procedure is that the burden of proof with respect to any claims presented lies, with certain rare exceptions, with the claimant. A party to legal proceedings in Finland is also ordinarily expected to plead its case primarily on the basis of the evidence that is available to it. For instance, US notions of discovery are not recognised under Finnish law, and a party seeking to obtain documents in the possession of counterparties or third parties is required to be able to specify such documents with relative precision.

ii Enforceability of foreign judgments and awards

There is no Finnish law that recognises all foreign judgments and arbitral awards globally. Therefore, enforcement in Finland of a non-Finnish judgment or arbitral award requires specific legislation that allows such recognition and enforcement.

Finland has adopted the 1958 New York Convention (the Convention on the Recognition and Enforcement of Foreign Arbitral Awards), and arbitral awards issued in any other contracting state are enforceable in accordance with the New York Convention, subject to certain, limited defences.

EU Regulation No 1215/2012 on the jurisdiction and the recognition of judgments in civil and commercial matters contains rules on the enforcement of judgments in another EU Member State (excluding Denmark). Finnish courts will recognise and enforce a final judgment rendered by a court in another EU Member State. The Lugano Convention of 2007 provides for similar recognition and enforcement in Finland of Danish, Norwegian, Icelandic and Swiss judgments.

Conversely, final judgments given outside the EU or EEA (for instance, in the US) are not automatically enforceable in Finland and require re-examination of the merits by a Finnish court. In seeking a Finnish court judgment, a judgment of a foreign court will constitute circumstantial evidence of the questions of fact in the case concerned and evidence of the governing law as applied to the matter in dispute.

VI ACQUISITIONS OF PUBLIC COMPANIES

i Principal legal and regulatory framework

Takeover bids for Finnish listed companies are regulated, primarily, by the Securities Market Act, the main legal framework regulating issuance of securities to the public and public trade in securities. The Finnish Companies Act regulates certain related matters such as compulsory acquisition of minority holdings in squeeze-out procedures following the public takeover bid.

In addition to the laws and regulations that apply to takeover bids generally, the articles of association of the target company may affect the way in which a bid is structured.

The Finnish Financial Supervisory Authority supervises compliance with the provisions of the Securities Market Act and gives guidance on their interpretation. Nasdaq OMX Helsinki

Exchange supervises the trading in publicly quoted securities in Finland. Compliance with national merger control regulations is supervised by the Finnish Competition and Consumer Authority.

The Securities Market Association has published the Helsinki Takeover Code, which contains recommendations relating to, *inter alia*, the preparation of a bid, due diligence, competing bids, holdings in the target company and the conditions of the completion of a bid.

ii Funds requirements

Prior to making a takeover bid, the offeror has a duty to ensure with sufficient certainty that it has the ability to fully meet the cash consideration requirement of the bid and take reasonable measures that may be required for the implementation of any other type of consideration.

The financing arrangement of the cash consideration may be conditional. The terms and conditions and elements of uncertainty relating to the financing arrangements that are relevant to the evaluation of the bid are to be made public when the bid is disclosed.

iii Voluntary takeover bids

Permitted conditionality

A voluntary takeover bid may be conditional, contrary to a mandatory takeover bid that may be conditional only upon requisite regulatory approvals.

Typically, a takeover bid is conditional upon merger clearances being obtained for the transaction. A conditional takeover bid is also often subject to the bid being accepted by at least a certain proportion of shares and voting rights in the target company (usually 90 per cent, which is the squeeze-out threshold for minority shareholdings).

The conditions of the offer must be transparent, unambiguous and reasonable. As a requirement of good practice, an offeror should not invoke a condition, unless it has material importance with respect to the transaction in question.

iv Mandatory takeover bids

Obligation to make a mandatory bid

A shareholder whose proportion of the voting rights in a listed company exceeds 30 or 50 per cent is under an obligation to launch an unconditional takeover bid for the remaining shares and other equity securities of the company. There are certain exemptions to this rule.

If a share pledge agreement provides that the voting rights are transferred to the pledgee, for instance upon an event of default, the above thresholds may be crossed when such event occurs or when the pledge is enforced. As a result, an obligation to make a mandatory bid obligation may arise.

Consideration

A mandatory bid under the Securities Market Act must be made at a fair price. The highest price paid by the offeror for the shares during the six months preceding the obligation to make the mandatory bid sets out the minimum price to be offered. The price so determined may be adjusted for special reasons, such as material changes in the target or on the market.

In the event that the offeror has not made any purchases during that period, the starting point for determining fair price is the volume weighted trading price of the shares during the three-month period preceding the obligation to launch a bid. Again, such price may be adjusted for special reasons. Where securities are offered as consideration in a mandatory bid, a cash consideration must always be offered as an alternative to securities.

v Squeeze-outs and risks of minority challenge

Under the Companies Act, a shareholder that holds more than 90 per cent of the shares and votes of a limited company is entitled, as well as obligated, to purchase the remaining shares in the company at fair market value.

Disagreements regarding the right to squeeze out minority holdings, including disagreements on the acquisition price, are settled in arbitration. Upon a party's application, the arbitration board of the Finland Chamber of Commerce appoints a panel of arbitrators. The award given by the arbitrators may be appealed to a district court, and further appealed to the Finnish Supreme Court, if leave to appeal is granted.

VII OUTLOOK

The Finnish financing market follows closely the trends of larger markets, London being the nearest and most influential. The Nordic banks, including Finnish banks, have been greatly affected by the turbulence in the wake of the unexpected result of the UK's EU referendum. While the EU and UK negotiate the exit terms, market instability caused by the uncertain situation is set to raise the costs of incoming financing of banks, and affect investments. Brexit is also very likely to have an impact on the position of London as the focal point of European financing transactions and it can be expected that more such transactions will be governed by, for example, German, Luxembourgish or French law. In Finland, the impact on borrowers will likely be limited. Large and stable companies who are coveted borrowers will continue to enjoy the development of favourable terms for their bank loans. At the same time, smaller companies will have more and more access to diversified sources of financing.

Bond financing is expected to retain much of its popularity due to investor appetite and the relative freedom from restrictive covenants for the issuers when compared with bank financing. The precedents of more diversified deal structures will be emulated and developed further in new transactions as the market becomes more familiar with the alternatives available. New legislation is being planned in order to lay the groundwork for more efficient Finnish bond market development. Proposed, near-final features include confirmation of the legal position of bondholder representatives, which currently remains unlegislated and untested in courts.

Nonetheless, traditional bank financing will still remain a source of debt financing for many Finnish companies.

The number of major Finnish companies in financial difficulties has remained relatively low with some isolated exceptions. Some of the companies with weaker balance sheets have been and may continue to be able to seize the market opportunity to issue high-yield debt instruments at rates that are lower than the current bank debt, with less restrictive covenants.

Chapter 10

FRANCE

Etienne Gentil, Hervé Diogo Amengual, Thomas Margenet-Baudry and Olivia Rauch-Ravisé[1]

I OVERVIEW

For a number of years, the French leveraged and acquisition market has been one of the most thriving and active markets in Europe, including for mid and large-cap transactions. This is the case despite the fact that France is not renowned for being a creditor-friendly jurisdiction, with the stated purpose of French insolvency law being to protect businesses as going concerns, to protect employment and (only thereafter) to pay creditors. Financing documentation, while drafted in English and usually based on English law Loan Market Association documentation for any deal that may be syndicated internationally, is often governed by French law. Larger, international financings, especially those involving high-yield and super-senior revolving credit facilities (SSRCF), will more typically be governed (for the bank financing and intercreditor agreement) by English law.[2] Security documentation will be governed by the law of the asset over which security is granted. Mezzanine and unitranche financing takes the form of bonds to avoid French banking monopoly issues. Mezzanine or unitranche with warrants will be drafted under French law. Some small-cap to small mid-market transactions have used relatively standardised 'Euro-private placement' documentation to finance acquisitions in the corporate (as opposed to leveraged) space.

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2 Please see Section VII, *infra*.

II REGULATORY AND TAX MATTERS

i French banking monopoly

Credit operations are defined by French banking law to include any transaction in which a person, acting for reward, makes available or undertakes to make available funds to another person. This includes in particular the making of loans and the purchase of unmatured receivables (i.e., loan receivables that are not past their due date) and the grant of bank guarantees or other forms of credit support for remuneration.

Pursuant to French law,[3] entering into credit operations on a 'habitual basis'[4] is a regulated activity in France that may only be carried out by an entity authorised under French law to conduct banking activities[5] or by an entity authorised to carry out credit operations in another EEA Member State and holding a European passport in order to carry out credit operations in France (i.e., an 'authorised credit institution'). Breach of these rules is subject to criminal sanctions.

However, the banking monopoly prohibitions only apply if the credit operation is performed in France; therefore, a loan transaction located outside France would not fall to be regulated by French law.[6]

The French banking regulations should therefore prevent a non-authorised credit institution from:

a granting new loans to a French borrower;
b committing to grant a loan to a French borrower; or
c taking on any other role in a financing transaction involving a French borrower that involves collecting and handling amounts on behalf of third parties and making them available to a French borrower (facility or administrative agent).

3 Articles L311-1 et seq. and Article L511-5 French Monetary and Financial Code.

4 'Habitual basis' has been interpreted by case law (Cass Crim, 5 February 1995; Cass Com 3 December 2002) as including credit transactions being entered into with more than one borrower. French case law has traditionally considered that occasional banking transactions do not fall under the banking monopoly; also there is some inconsistency in case law in that respect (see Cass Com 3 December 2002 versus Cass Com 7 January 2004).

5 Credit institutions, financing companies and certain entities benefitting from exemptions or derogations pursuant to Articles L511-6 and L511-7 French Monetary and Financial Code.

6 The location of a loan transaction is a factual matter determined by the courts, which for this purpose take into account a number of elements, including: the nationality of the borrower; whether the funds were made available in France or effectively used or earmarked to be used in France; whether canvassing or cold-calling was performed in France; the place where negotiations took place; the place of execution of the loan documentation; the governing law of the loan documentation; and the currency in which the loan is denominated (this criteria having probably become less relevant now that the French currency is shared with a number of other European countries). Removing the French aspect of as many of these elements as possible will reduce the likelihood of having the corresponding banking transaction held by a French court as being located in France and therefore subject to the French banking monopoly.

Conversely, the French banking regulations would not prevent a non-authorised credit institution from:

a purchasing a previously extended term loan to a French borrower, provided that the purchase transaction was entered into and performed outside France;

b entering into a sub-participation entered into and performed outside France; or

c granting or committing to grant capital markets (bond or notes) financing to a French borrower.

In addition, various new exceptions to the French banking monopoly regime were introduced under French law in 2016, allowing in particular some limited liability companies to grant loans of less than two years to microentеprises, small and medium-sized enterprises, or intermediate-sized enterprises[7] with which the lender has certain 'economic ties'.[8] Such economic ties include being part of the 'same group of economic interest' (as defined) or having established commercial relations. In addition, the borrowing companies are subject to minimum cash and capital requirements, and the total amount of loans granted to a company and the total amount of loans granted by a single borrower are subject to a per annum cap. While this new regime is unlikely to be applicable to or facilitate acquisition financing structures, it is regarded by a number of French academics and practitioners as an interesting first step in that direction.

ii Sanctions, anti-corruption and anti-money laundering

There are no transparency constraints specifically applicable to leveraged finance in France. General anti-bribery and anti-money laundering laws and regulations apply to this area of activity. The French anti-bribery package[9] implements international and European frameworks or rules.[10]

7 Microenterprises are defined as enterprises with no more than 10 employees and €2 million in total annual turnover or balance sheet; SMEs as enterprises with no more than 250 employees and €50 million in annual turnover or €43 million in total balance sheet; intermediate-sized enterprises are defined as enterprises with no more than 5,000 employees and €1.5 billion in total annual turnover or €2 billion in total balance sheet.

8 Law No. 2015-990 of 6 August 2015, amending article L511-6 of the French Monetary and Financial Code, and Decree No. 2016-501 of 22 April 2016, creating articles R511-2-1-1 and R511-2-1-2 of the French Monetary and Financial Code.

9 Articles 435-1 et seq. of the French Criminal Code with respect to international corruption; and Articles 432-11 et seq., 433-1 et seq. and 445-1 et seq. of the French Criminal Code with respect to domestic corruption. The French anti-bribery package is likely to be further be extended by the government-sponsored 'Sapin II' law on transparency, anti-corruption and economic modernisation (not enacted or implemented at the time of writing.

10 France is a party to the Criminal Law Convention and the Civil Law Convention on Corruption of the Council of Europe, the United Nations Convention against Corruption and the OECD Convention. The European Council Framework Decision 2003/568/JHA of 22 July 2003 on combating corruption in the private sector is applicable in France.

France transposed Directive 2005/60/EC[11] in 2009. One of the most significant obligations for relevant credit institutions is the 'know your customer' requirement for customers for any transaction in excess of €15,000.[12]

Credit institutions should also be mindful of economic or trade sanctions or other restrictive measures enacted, administered or enforced notably by the Office of Foreign Assets Control in the US, the United Nations Security Council, the European Union or the French Ministry of the Economy.[13] Evidence that lenders are not assisting their borrowers in breaching sanctions or money-laundering rules and regulations is shown through detailed representations and warranties and undertakings increasingly imposed on obligors in finance documentation, in particular since the US$8.9 billion fine imposed on BNP Paribas by the US Department of Justice in July 2014 for violating US sanction controls affecting Sudan, Iran and Cuba between 2002 and 2012.

iii Other regulatory concerns

Control on foreign investments

The list of strategic sectors in which foreign investments in France require prior authorisation of the French Economics Minister,[14] which already included national defence and information technology, was broadened in March 2014 to include energy, transport, water, public health and telecommunications where they are essential to guarantee French national interests in terms of public policy, public security or national defence. Investments in these additional strategic sectors are regulated even if the investors are EU investors.[15]

Effective global rate

While usury limitations no longer apply to loans to corporations, French law[16] requires that the effective global rate (TEG) applicable to any loan granted to a French borrower be mentioned in all lending agreements (in other words, it should be communicated for the first time no later than the signing date).[17] The TEG, calculated in accordance with specific regulations, must be communicated to the borrower for each loan made available to it and for the first time at the time the document creating the loan is entered into (i.e., signing rather than closing). Failure to duly notify the TEG could result in the contractual interest rate to be void as against the French borrower and replaced by the (currently extremely low) statutory

11 Directive 2005/60/EC of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing, transposed into French law by Articles L561-1 to L562-11 of the French Monetary and Financial Code.

12 Articles L561-5 and R561-10 of the French Monetary and Financial Code.

13 Articles L562-1 and L562-2 of the French Monetary and Financial Code.

14 Article L151-3 of the French Monetary and Financial Code.

15 See Latham & Watkins Client Alert No. 1688, 16 May 2014.

16 Articles L314-1 et seq. and R313-1-0 et seq. of the French Consumer Code; Article L313-4 of the French Monetary and Financial Code.

17 A number of courts of first instance have determined that failure to communicate the TEG with a summary of the principal terms of the financing before the financing documents themselves were finalised and signed could breach the above rules. No superior French court has so far issued a decision on this topic.

rate of interest, and in the lender being subject to fines. The rules do not apply to bond financings. The TEG regime, conceived to inform and protect consumers, is clearly wholly inappropriate to provide adequate information to borrowers under more complex financing transactions such as the ones into which businesses routinely enter, but nonetheless applies to them. Financial institutions and practitioners hope that the regime will be reformed soon[18] so as remove this unnecessary shackle on, and uncertainty affecting, loans to businesses in France, with a view to bringing France in line with just about every other country in Europe and its other major trading partners around the world.[19]

Exchange controls

As a general rule, there are currently no exchange controls for the transfer of funds between a resident in France and any person or entity abroad.

iv Tax issues

From a French tax standpoint, the main tax structuring issues will relate to being able to deduct the interest incurred on the acquisition debt financing, the ability of the acquisition vehicle to get access to the cash of the target group at minimal tax costs in order to service its acquisition debt and avoiding the application of withholding taxes.

Interest deductibility

Interest paid or due by a borrower under a debt instrument is generally deductible from the taxable results of the financial year in which such interest is accrued, provided that the corresponding loan is contracted for business purposes and the interest rate is set on arm's-length terms.

Since 2013, interest deduction has been subject to a general limitation rule, according to which the aggregated net financial expenses incurred by companies are deductible (for fiscal years starting as from January 2014) only up to 75 per cent of their amount, unless their total amount in the relevant fiscal year does not exceed €3 million (such rule applying on a consolidated basis in the case of companies belonging to a tax group).

Interest deductibility is also limited by specific rules, including in particular the rule applying to related-party or deemed related-party debts (also known as thin-capitalisation rules): interest on loans granted by direct or indirect controlling entities (or by entities under the same control as the French borrower) is only deductible if:

a a 1.5:1 debt-to-equity ratio is met (computed by reference to the net equity of the borrowing entity or its share capital if higher);

b such interest does not exceed 25 per cent of the borrowing company's adjusted current result; or

18 Pursuant to Article 4 of Law No. 2014-844 of 29 July 2014, the French government was required to submit in 2015 to parliament a report containing proposals for a reform of the French regulation concerning the effective global rate applicable to businesses. At the time of writing, no such report had been produced.

19 Research in September 2015 has shown that only Bulgaria, France, Portugal and Slovakia (to a certain extent) applied this type of constraints on loans to businesses in the EU.

c interest paid on related-party loans by the borrowing company does not exceed interest received by the latter on loans it has itself made to related parties.[20]

Loans granted by third parties (i.e., bank debts) secured by a company related to the borrower also fall within the scope of thin-capitalisation rules, subject to certain safe harbours: amounts borrowed as a result of an eligible public offering of bonds (typically excluding high-yield bonds), and amounts borrowed to reimburse an existing debt due to a change of control of the borrower, or the reimbursement of which is guaranteed only by certain security interests.

There has been an accumulation of new rules and restrictions in this respect over the past few years,[21] rendering the structuring of acquisition financing ever more complex.

Specific attention should be paid to the evolution of the international and European tax frameworks that may affect French tax legislation on interest deductibility. In particular, a new EU Directive (ATAD) includes a mechanism under which adjusted net financial expenses incurred by an EU company will be deductible from its taxable results only up to 30 per cent of EBITDA.[22] In the absence of any formal announcement by the French tax authorities as to how ATAD will be transposed into French law,[23] the implications of these new limitations cannot be assessed with certainty at this stage.

The effective deductibility of interest expense against operating income will typically be achieved through the implementation of a tax consolidation between the acquisition vehicle incurring the debt and the profit-generating French operating companies of the target group of which the acquisition vehicle holds at least 95 per cent of the capital and voting rights.

In the absence of tax consolidation, interest and transaction costs incurred by the acquisition vehicle will only be deductible against the acquisition vehicle's own taxable revenues, which should be very limited. Debt pushdowns or internal reorganisations can also be envisaged but should be reviewed on a case-by-case basis to avoid abnormal act of management or abuse of law issues.

20 The portion of interest on related-party loans that exceeds the highest of the above three limits is not deductible from the taxable results of the borrowing company in respect of the fiscal year in which it has accrued, except in the case where it does not exceed an amount of €150,000 per year. The non-deductible portion of interest can be carried forward subject to certain conditions and subject to a 5 per cent discount each year (after the second year).

21 For example, the 2014 Finance Law introduced new limitations with respect to interest on hybrid instruments with a broad scope of application.

22 EU Member States will have the right to set up a safe harbour mechanism pursuant to which net financial expenses could be deductible up to a maximum amount of €3 million.

23 ATAD should in principle enter into force in January 2019 provided that EU Member States with domestic targeted rules for preventing base erosion and profit-shifting risks at the date of entry into force of ATAD that are effective as the provisions of this EU Directive continue to apply these targeted rules until the earlier of the end of the first full fiscal year following the adoption by the OECD of a minimum standard with regard to BEPS Action 4 (the purpose of which is to limit base erosion involving interest deductions and other financial payments) and January 2024.

Cash upstreaming to acquisition vehicle

As regards the capacity to upstream cash to the acquisition vehicle to enable it to service its debt, the target may distribute dividends at limited tax costs; subject to certain conditions, dividends are exempt from corporate income tax up to 95 per cent of their amount at the level of the recipient[24] (up to 99 per cent if the distribution occurs between tax-consolidated entities or, subject to certain conditions, between a French company that belongs to a French tax-consolidated group and its 95 per cent or more subsidiary located in another EU Member State).[25] In the absence of distributable reserves at the level of the target group, fully exempt share capital reductions may also be envisaged to upstream cash to the acquisition vehicle.

In addition, if a tax-consolidated group has been created between the French target and the French acquisition vehicle, the latter may service its debt from the cash tax savings resulting from the application of the tax consolidation regime.

Withholding tax

Interest and similar payments are exempt from withholding tax in France to the extent that such interest and similar payments are not paid outside of France on an account opened with a financial establishment in a 'non-cooperative state or territory' (ETNC)[26] or to a beneficiary incorporated or acting from a facility office located in an ETNC or, if made into an ETNC, the French borrower is able to demonstrate that the main purpose and effect of the loans is not to locate revenues in an ETNC.

The main impact of that legislation is that a 75 per cent withholding tax is *prima facie* applicable to payments made into an ETNC.[27]

Certain debt instruments (including in particular high-yield bonds in general) are automatically exempt without the debtor having to provide any proof of the main purpose and effect of the transaction.

III SECURITY AND GUARANTEES

i Financial assistance and corporate benefit

The French Commercial Code prohibits the grant by a corporation (SA) or a simplified joint-stock company (SAS) company[28] of 'financial assistance' for the acquisition or the

24 Thus an effective maximum taxation of only approximately 1.9 per cent.

25 See above for more detail on the conditions of application of the tax consolidation regime in France. A 3 per cent contribution also applies on distributed income except between tax-consolidated entities.

26 Within the meaning of Articles 125 A III and 238-0A of the French Tax Code. The list of ETNCs is updated annually, and currently includes Botswana, Brunei, Guatemala, the Marshall Islands, Nauru, Niue and (from January 2017) Panama.

27 Subject to exceptions, such payments of interest shall also not be tax-deductible for the borrower.

28 These are the types of French companies most likely to be involved as obligors or material subsidiaries in an acquisition financing.

subscription of its own shares by a third party. A loan, guarantee, other security interest or other type of financial assistance granted in breach of such statutory provisions would be void and may make the lender subject to criminal liability.

There is an overriding requirement that a French corporation derives corporate benefit from transactions in which it takes part. Any credit support granted by a French corporation must be granted as part of a transaction that, taken as a whole, is in the corporate interest of the corporation, failing which the credit support may be void. A limited concept of 'group benefit' has been recognised by case law[29] but is in practice never relied upon in acquisition financing to justify upstream or cross-stream guarantees.

Officers of a French corporation that knowingly use its assets or credit directly or indirectly for personal gain[30] and in a way that is contrary to its interests may be liable to personal criminal or civil liability.[31] While it is for the officers of a French corporation to determine whether corporate benefit exists for the corporation, third-party lenders in acquisition financings, with knowledge of the sources and uses of funds, should not ignore situations that are clearly in breach of the above rules in a way that could make them accomplices to a criminal offence or render the credit support void, or both.

ii Guarantee of third-party obligations

The guarantee by a French company of third-party obligations requires in particular that the following conditions be met:

a it must be part of the corporate object of the guarantor;

b the guarantor must derive an actual benefit from the transaction involving the granting by it of the guarantee taken as a whole. Downstream guarantees should meet these criteria, since they presumably allow a direct or indirect subsidiary of the guarantor to incur financing and develop its business, which should in due course be of benefit to its shareholders. Side-stream or upstream guarantees would usually not meet this criteria unless, for example, the guarantees are granted on a reciprocal basis[32] and the quantum guaranteed is commensurate with the facility made available to the French guarantor or its subsidiaries;

c the guaranteed amounts must be commensurate with the financial capabilities of the guarantor or amount of its assets; and

d for French tax reasons, and whatever the type of guarantee (upstream, cross-stream or even downstream), there should be appropriate consideration paid to the guarantor, in particular where the guaranteed party is a foreign subsidiary.[33]

iii Over-collateralisation

In the event of any safeguard, reorganisation or liquidation judicial proceedings affecting a debtor, the French courts have the power to cancel or reduce security interests granted by it

29 *Affaire Rosenblum*, Cass Crim February 1985, JCP ed G II, 1986.

30 This could include acting in a way that favours another entity of the group.

31 Article L241-3 and L242-6 of the French Commercial Code.

32 For example, a revolving credit facility made available to a number of entities within a group of companies.

33 CE 17 February 1992, No. 81690-82782, 9e et 7e s.-s, *Carrefour*; RJF 4/92, No. 433.

in consideration of the facilities provided to it if such security interests are 'disproportionate' to such facilities[34] and if the grant of the facilities that the security interests secured was itself wrongful.[35]

iv Types of security interest available under French law

There is no omnibus form of security interest under French law; each type of asset is secured under a form of security interest that has a specific regime and requirements. Security interests are most commonly granted in French acquisition financings over shares, bank accounts, receivables, intellectual property rights and (less frequently) stock and inventory.

The grant of security interests by a guarantor is subject to the same corporate benefit and financial assistance limitations as apply to the grant by it of its credit support.

Shares of companies such as SAs or SASs or other French law-governed financial instruments (bonds, warrants, etc.) are pledged by having a security granted on a special securities account in which the financial instruments are registered. A 'statement of pledge' of the securities account is signed by the pledgor, notified to the registrar of that securities account and noted by it on the account. While no other perfection formalities are required, in practice the registrar delivers a certificate of pledge. A special bank account is designated in the pledge instrument into which dividends, etc., are directed to be paid, and from which the pledgor is typically allowed freely to remove all amounts until certain specified events occur and the account may be blocked.

Pledges of shares of other types of corporations (SARL, *société civile*, etc.) follow another regime specified by the French Civil Code, and must be executed in the French language for perfection purposes.

A security assignment of receivables (known as a '*Dailly*' assignment) may only secure borrowing obligations due to an authorised credit institution, and may not secure guarantee obligations, obligations under a bond instrument or (most likely) 'parallel debt' obligations (see Section III.vi, *infra*). The assignment document must include certain mandatory provisions, failing which it will be ineffective. Perfection formalities are extremely limited and simple, and the security interest remains enforceable even if the assignor is subject to insolvency proceedings that stay enforcement against it (see Section III.v, *infra*).

Where a '*cession Dailly*' of receivables is not available, a Civil Code pledge of receivables may be used. However, its enforcement against a borrower or pledgor that is subject to insolvency proceedings will be stayed.

Security over the purchaser's rights under warranties and indemnities granted by the seller under a share purchase agreement would be obtained under a Civil Code pledge of receivables, a tripartite delegation agreement between the vendor, the purchaser and the security agent;[36] or (if available) a *Dailly* assignment of receivables.

34 Article L650-1 of the French Commercial Code.

35 Cass Com 27 March 2012.

36 In a delegation agreement, the vendor undertakes to pay directly to the security agent the amounts (if any) that it comes to owe to the purchaser under the SPA with respect to warranties and indemnities, the payment of those amounts constituting a discharge *pro tanto* of the amounts owed by the purchaser or borrower to the lenders under the financing.

French law intellectual property rights are pledged by the pledgor signing a pledge agreement with the pledgee, and this pledge being noted on the public register (or registers) in which the relevant intellectual property rights are registered. The pledge agreement may be entered into in the English language with a translation in French for registration purposes.

A pledge over bank accounts may be granted under an agreement that is perfected by being notified to the bank (or banks) holding the pledged account. They may be entered into in the English language. It is possible to notify the bank that, notwithstanding the pledge, it may allow the account to be operated without restriction, unless and until it is notified otherwise by the pledgee. The pledge will be subordinate to the account bank's set off rights under its general terms of business, unless waived by it.

To be included in a pledge over a business as a going concern,[37] assets must be specifically listed. Such a pledge does not preclude the pledgor from disposing of items comprising the pledged business as long as not all or substantially all of the business is disposed of thereby. This form of security interest having been developed to secure the financing of small corner-shop businesses, it should not be confused with an English law floating charge, and is usually inappropriate for large entities of the type involved in LBO transactions, although it is sometimes requested in leveraged financing transaction. It must be registered within 15 days of its grant, failing which it is void.

A pledge over moveable assets such as stock or inventory may be created:

a under a Civil Code regime[38] where the pledged assets remain with the pledgor or where custody of the pledged assets is transferred, either to the pledgee or to a third-party custodian and are filed with the appropriate trade registry for perfection purposes; or

b under a Commercial Code regime[39] that is available only to authorised credit institutions to secure credit facilities granted to the pledgor.[40]

Security over real estate is typically not obtained in the French acquisition finance market because of the *ad valorem* stamp duty and notarial fees required to be paid (approximately 1 per cent of secured amount).

Various bodies have been pushing for a reform and simplification of the French security interest regime.[41] A committee of academics chaired by Professor Michel

37 Aggregation of the company and business names, leasehold interest, goodwill, business furnishings, and tools and equipment used by the business, and the intellectual property rights of the business.

38 Articles 2333 et seq. of the French Civil Code.

39 Article L527-1 et seq. of the French Commercial Code.

40 The previous doctrinal and case law uncertainty as to whether the Civil Code regime was available to authorised credit or financial institutions or whether they must mandatorily use the Commercial Code regime has been resolved (in favour of freedom of choice), and the Commercial Code regime has been simplified and improved, by Ordinance No. 2016-56 of 29 January 2016, applicable as from 1 April 2016. Uncertainty as to the validity of Civil Code stock or inventory pledges granted in favour of authorised credit or financial institutions prior to 1 April 2016 remains.

41 See in particular report by Paris Europlace, 'Comité de Droit financier – Commission Droit des sûretés – Quelques proositions de modernisation et simplification du droit des sûretés français', 1 September 2015.

Grimaldi had provided some recommendations to reform this regime in 2005,[42] and these recommendations had been followed in some respects by the government and parliament in the 2006 reform of the French Civil Code.[43] The government has tasked that committee in 2016 to prepare a new report and make new recommendations on the matter.

v Enforcement of security interests

Enforcement assuming no insolvency of grantor

French security interests may be enforced through a sale by public auction or by judicial foreclosure pursuant to a court order. In addition, a number of security interests may be enforced through contractual foreclosure when it is so agreed by the pledgor and pledgee, including in the pledge instrument: a third-party expert is appointed pursuant to the agreement to determine the value of the pledged asset, and the asset is transferred to the pledgee in consideration for a set off against the secured debt in an amount equal to the value so determined. For rather unclear reasons, contractual foreclosure is not available in particular in the case of pledges over a business or Commercial Code pledges over moveable assets.

Pledges over listed shares may also be enforced on the stock market without requiring a court order, although issues arise where enforcement is sought over a holding whose size is such that its value is not reflected by the official listed price which must be used for enforcement purposes.

Security assignments of trade receivables (*cession Dailly*) may be enforced without a court order since the beneficiary of the security assignment is already the absolute owner of the receivables.

Stay of enforcement against a grantor of security interest subject to French insolvency-related proceedings[44]

The commencement of French law-governed safeguard or other insolvency proceedings against the grantor of security interests will have the effect of staying or prohibiting all enforcement proceedings (including any contractual foreclosure) against such grantor otherwise than as part of the court-administered proceedings.[45]

This stay on enforcement will not affect a *Dailly* security assignment (for the reasons mentioned above).

'Double Luxco' structures

Since 2009, creditors have sought to safeguard the strength of their security packages with respect to leveraged or acquisition financings granted to French bidcos by obtaining security granted by non-French security providers over the shares of the French bidco or of the holding company of the French bidco, enforcement of which would not be hampered

42 'Rapport du groupe de travail relatif à la réforme du droit des sûretés', dated 28 March 2005.

43 Ordonnance No. 2006-346 of 23 March 2006.

44 This should not be understood as constituting an exhaustive description of the effect of insolvency on the rights of creditors of French entities and beneficiaries of security interests governed by French law.

45 Articles L622-7 and L622-21 of the French Commercial Code.

by French insolvency-related proceedings including 'hostile' safeguard proceedings being commenced by the debtor. However, pursuant to the EC Insolvency Regulation,[46] which applies throughout the European Union (other than Denmark), the courts of the Member State in which a company's centre of main interests (COMI) is situated has jurisdiction to open main insolvency proceedings against it. The concern thus remained that it could be shown that the non-French holding company that had granted security over the shares of the French Bidco had its COMI in France and could be made subject to French insolvency-related proceedings. Therefore, a construct – the double Luxco structure – has been developed to minimise this risk by:

a obtaining as part of the security package a Luxembourg law pledge from a Luxembourg entity (Top Luxco) over the shares of another Luxembourg entity limited by shares (Luxco), which itself grants security directly or indirectly over the French Bidco. For various technical reasons related to the drafting of Article 5 of the EC Insolvency Regulation, such share pledge would not be affected by French insolvency-related rules staying enforcement of security interests, even if it was shown that Top Luxco and Luxco had their COMI in France and were effectively made subject to French insolvency-related proceedings; and

b including a number of features, covenants and representations as part of the financing and security package to minimise the risk that the Top Luxco and Luxco be shown to have their COMI in France in the first place and made subject to French insolvency-related proceedings.

Because French insolvency law now allows certain creditors to submit a safeguard plan proposal which could be adopted instead of the one put forward by the debtor (see Section IV.iii, *infra*), some debtor advisers have put forward the view that this has substantially reduced the likelihood of a debtor opening hostile safeguard proceedings and weakens the case for arrangers insisting on a double Luxco structure being put in place. Either for this reason, or more likely simply because of market forces, it would appear that no new double Luxco structures have been implemented since mid-2015. It cannot be ruled out that changes in market conditions could require them to be reintroduced at some stage.

vi Security agents and parallel debt

Under French law, security interests require that the pledgee and the creditor be the same person. Security is granted to the lenders (represented by the security agent) rather than to the security agent. There is no concept of trust or security trustee under French law to enable security to be granted to a single entity that holds it on behalf of a fluctuating pool of beneficiaries, as exists under common law systems. Concepts of fiduciary ownership and

46 Council Regulation (EC) No. 1346/2000 of 29 May 2000 on insolvency proceedings. This is in the process of being replaced by Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast), which shall apply as from 26 June 2017 to insolvency proceedings commenced after that date.

fiduciary security[47] and a statutory security agent regime[48] were introduced into French law in 2007, but the regime includes a number of substantial rigidities or imperfections that have deterred most practitioners from using it in acquisition financing.[49]

In the context of international financings where the parties choose English or New York law to govern their financing documents, it is quite customary to set up a 'parallel debt' construct in favour of the security agent. This parallel debt mirrors the obligations of the principal obligors towards the creditors, and will be at all times in the same amount and payable at the same time as the principal obligations, any payment in respect of the primary obligations discharging the corresponding parallel debt, and *vice versa*. Pursuant to the parallel debt construct, the security agent (parallel debt creditor) becomes the holder of a direct claim against the obligors, which may be secured by the grant of security in its favour. In its *Belvédère* ruling,[50] the French Supreme Court recognised (in relation to bond documentation governed by New York law) the enforceability in France of certain rights (the filing of claims in safeguard proceedings) of a parallel debt creditor to the extent it did not expose the French debtor to a risk of double payment.

IV PRIORITY OF CLAIMS

i Preferred creditors and claims

French insolvency law assigns priority to the payment of certain preferred creditors, including employees, officials appointed by the insolvency court, creditors who, as part of court-approved conciliation agreements, have provided new money or goods or services, post-petition creditors, certain secured creditors (essentially in the event of liquidation proceedings) and the French state (taxes and social charges).

There is no concept of equitable subordination under French law that would require equity holders of a debtor to see their claims as creditors treated differently from the claims of other creditors.

ii Intercreditor agreements

Intercreditor agreements in the context of French leveraged financings tend to be based on LMA standards, with certain additional features:

a double Luxco structures (where still applicable), where enforcement would most likely have the secured creditors enforcing the Luxco Luxembourg law share pledge and thus become shareholders of the Luxco, require that none of the sponsor vehicles, Mancos or other creditors that were intended to be structurally subordinated to the secured creditors remain in place post-enforcement as structurally senior to the secured creditors *qua* shareholders of the Luxco; and

47 Article 2011 et seq. of the French Civil Code.

48 Article 2328-1 of the French Civil Code.

49 The proposed, government-sponsored 'Sapin II' bill on transparency, anti-corruption and economic modernisation would provide for authority to the government to reform the French security agent regime in a way that is seen helpful by many practitioners.

50 Cass Com 13 September 2011 No. 10-25533.

b security interests governed by French law may only secure a creditor up to the secured amount that is due and unpaid to it. If the secured creditors choose to enforce pledges over securities by way of foreclosure, the secured liabilities would be deemed extinguished up to the value (determined by an expert) of the foreclosed securities. If such value exceeds the amount of secured debt, the secured creditor may be required to pay the pledgor a cash amount equal to the difference between the value of the securities as so determined and the amount of the secured debt (regardless of the actual amount of proceeds ultimately received by the secured creditor from a subsequent on-sale of the shares). Such payment may need to occur at a time when the creditor has not on-sold the foreclosed shares and has not received any cash further to its enforcement. Intercreditor agreements require the cash amount to be paid to the benefit of the security provider into a pledged account and paid back into the waterfall, so that the security providers are not effectively paid until the secured creditors have been discharged in cash.

There is no law or published decision of any senior French court on the validity or enforceability of intercreditor or subordination agreements. These may include provisions that challenge fundamental principles of French law (such as the requirement of parties to waive rights before they have come into existence, or provisions that purport to renew rights that have expired or to ignore the discharge of debts made pursuant to payments because the creditors reallocated them among themselves as per a different waterfall). The French Commercial Code provides[51] that, in the context of safeguard or judicial reorganisation proceedings, the safeguard or judicial reorganisation plan 'takes into consideration' the provisions of subordination agreements between creditors that were entered into prior to the opening of the safeguard proceedings; however, it remains unclear to what extent a French court would give effect to many provisions of intercreditor arrangements, irrespective of their governing law.

iii Safeguard or judicial reorganisation plans, creditor votes and shareholder 'cramdown'

Safeguard (including accelerated safeguard and accelerated financial safeguard) or judicial reorganisation proceedings give rise to the adoption of a 'safeguard' or 'reorganisation' plan. In the case of large companies (those with more than 150 employees or a turnover greater than €20 million), or at the debtor's or the court-appointed administrator's request accepted by the bankruptcy court, adoption of the safeguard or reorganisation plan requires the positive vote of certain creditors whose claims arose prior to the judgment commencing the proceedings[52] regrouped as follows:

51 Articles L626-30-2 and L626-32 of the French Commercial Code.

52 The payment of all pre-proceeding claims is prohibited with the exception of certain claims that may be paid by way of set-off or, by special authorisation of the bankruptcy judge if the payment is required in order to recover or obtain assets required for the continued operation of the business (Article L622-7 of the French Commercial Code).

a a creditors' committee regrouping credit institutions or assimilated institutions and entities having granted credit or advances in favour of the debtor (the credit institutions committee);

b a creditors' committee regrouping suppliers having a claim that represents more than 3 per cent of the total amount of the claims of all the debtor's suppliers and other suppliers invited on to this committee; and

c a single general meeting regrouping all holders of bonds or notes or equivalent debt securities.

Adoption of the plan requires its approval by a two-thirds majority vote in each committee and in the general bondholder meeting.[53]

Until July 2014, the safeguard or reorganisation plan was prepared by the debtor in cooperation with the court appointed administrator before being submitted to the vote. Since then, creditors that are members of the credit institutions committee or of the major suppliers committee may prepare an alternative plan that must also be submitted to the vote of the committees and of the general bondholders meeting.[54]

In the context of the adoption of a plan in safeguard or judicial reorganisation proceedings, each member of a creditors' committee and each bondholder must inform the court representative of the existence of any agreement relating to the exercise of its vote, to the full or total payment of its claim by a third party as well as of any subordination agreement. The court representative shall then submit to such creditor or bondholder a proposal for the computation of its voting rights in the relevant creditors' committee or meeting. In the event of disagreement, the matter would be decided by the relevant court in summary proceedings.[55]

As from August 2015, as a result of the 'Macron Law', in judicial reorganisation proceedings if (1) the company has at least 150 employees, or controls one or more companies with an aggregate of at least 150 employees, (2) the disappearance of the company is likely to cause serious harm to the national or regional economy, and (3) a share capital increase in favour of new investors seems to be the only credible way to avoid such disappearance, then, provided that the existing shareholders have voted against such share capital increase, the insolvency court may either:

a appoint a court officer in order to vote the share capital increase provided for in the reorganisation plan; or

b order, in favour of the new investors, the sale of all or part of the share capital held by the shareholders that refused the share capital increase and hold either a majority, or a blocking minority, of the voting rights, in which case:
   - the price of the shares will, failing agreement between the parties, be set by an expert designated by the court in summary proceedings; and

53 In accelerated financial safeguard proceedings, only the creditors' committee of credit institutions and the general bondholders meeting vote, because such proceedings do not prevent the payment of pre-proceeding claims to suppliers, or to creditors other than credit institutions or bondholders, that continue to be paid in the ordinary course.

54 Bondholders are not entitled to present their own alternative safeguard or reorganisation plan.

55 Articles L626-30-2 and L.626-32 of the French Commercial Code.

- the minority shareholders have the right to withdraw from the company and request that their shares be purchased by the new investors.

In either of the above cases, the reorganisation plan is subject to the undertaking of the new shareholders to hold their shares for a certain time period set by the court which may not exceed the duration of the reorganisation plan.

V JURISDICTION

French courts would recognise the choice of a foreign law to govern agreements to which a French entity is a party by applying the Rome I Regulation[56] in relation to contractual obligations and (if applicable) Rome II Regulation[57] in relation to non-contractual obligations, and nothing French-specific needs to be mentioned in this respect.

Likewise, French law would recognise the submission by a French entity to the jurisdiction of a foreign court as valid and binding and not subject to unilateral revocation, assuming it to be effective in such foreign courts as a matter of the laws of such jurisdiction and if not made with the intention of avoiding the application of mandatory provisions of French law or of the laws of another relevant jurisdiction.

A judgment for a sum of money due under the finance documents (other than an *ex parte* judgment which has not been notified to the defendant prior to seeking enforcement) obtained in a properly selected foreign court (see above) from another EU Member State and enforceable in that state against a French party will be recognised and enforceable in France without any special procedure being required, subject to and in accordance with Regulation (EU) No. 1215/2012,[58] and nothing French-specific needs to be mentioned in this respect.

A final judgment for a sum of money due under the finance documents obtained against a French party in the courts of a properly selected foreign court (see above) that is not an EU Member State would be recognised and enforceable by the French courts without re-examination of the matters adjudicated, through an action for *exequatur* brought before the competent French court, provided that the court is satisfied that the requirements developed by case law for the enforcement of foreign judgments in France are met.

After several years of unhelpful fluctuations in case law in this respect, the current – apparently settled – approach of French Supreme Court case law[59] is that an 'asymmetrical' jurisdiction clause (i.e., pursuant to which one party submits to the exclusive jurisdiction of a

56 Regulation EC No. 593/2008 of 17 June 2008 on the law applicable to contractual obligations.

57 Regulation EC No. 864/2007 of 11 July 2007 on the law applicable to non-contractual obligations.

58 Regulation (EU) No. 1215/2012 of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (known as the 'Brussels I Regulation (Receast)').

59 Cass civ 1ère Chambre, 7 October 2015, No. 14-16.898.

court and another party has a discretionary option to choose one or more other jurisdictions) would be held valid by French courts provided it is possible for the parties to identify the jurisdictions that may be competent by virtue of such clause.

VI FINANCING ACQUISITIONS OF FRENCH LISTED COMPANIES

Leveraged financing of the acquisition of French listed companies must take the following aspects in particular into account.

Generally, the acquirer would first acquire from a controlling or reference shareholder a significant portion of the share capital of the listed company before launching a tender offer.

Where a person crosses a 30 per cent threshold of share capital or voting rights in a French-listed company, it is required to launch a mandatory tender offer for all the shares held by third parties.[60] Lenders enforcing their share pledge over a number of shares exceeding this threshold would themselves have an obligation to launch a mandatory tender offer.

A tender offer must be for all the shares of the listed target,[61] which requires financing to be available to purchase all the shares that are not already owned or controlled by the initiator of the tender offer.

Presenting banks are required to guarantee absolutely the settlement of the tender offer.[62] They often therefore require the money necessary to pay for the tendered shares to be available, or a counter-guarantee from the lenders financing the acquisition on a very strong, certain funds basis (such as certain funds typically not being as strong as the regulatory obligation of the presenting bank or banks), or a first-demand bank guarantee. There are no regulatory restrictions on syndicating the financing prior to it being drawn (provided insider-trading regulations are complied with); however, presenting banks and counter-guarantors will seek to restrict it to minimise the risk of co-lender default.

The completion of a tender offer may be suspended by a challenge before the courts.[63] If the tender offer is allowed to go ahead at the end of the court proceedings, the offer will customarily be reopened for a period of eight stock exchange days after the court decision,[64] during which the party that initiated the tender offer or the presenting bank (or banks) will wish to still have recourse to the financing, although whether by then it is still available is a matter for negotiation.

60 Ibid. See also L433-3.I, paragraph 1 of the French Monetary and Financial Code.

61 Article 234-2, paragraph 1 of the General Regulations of the French Financial Markets Authority (AMF).

62 Article 231-13, paragraph 2 of the AMF General Regulations.

63 By way of recent example, the offer by Ardian and Fosun for Club Med was suspended for nine months (from August 2013 until the end of April 2014) by a challenge from minority shareholders.

64 Articles R621-44, R621-45 and R621-46 of the French Monetary and Financial Code and Article 231-34 of the AMF General Regulations.

The initiator of the offer is required to disclose as part of the documents that are filed and available to the public the principal terms of its financing (including the impact that this may have on the assets, activity and results of the relevant companies),[65] which would include in particular fees and commissions, interest payable and (if applicable) flex terms.

VII OUTLOOK

Market players and practitioners are relatively quick to adopt trends from the United Kingdom or the United States and, after being one of the first continental jurisdictions to implement SSRCF and high-yield financings, the market saw a number of transactions involving acquisitions financings or refinancings of substantial French assets using covenant-lite or covenant-loose US 'Term Loan B'-type financings, whether under New York law or adapted to English or French law. The government is looking at further reforming the French insolvency rules, although whether this will be done in a way that will bring France more in line with other jurisdictions, in terms of creditor protection, or indeed whether it will have any positive or negative impact on the activity of a strong market, remains to be seen. It is too early to determine what the effects of Brexit will be on structuring and documenting acquisition and leveraged finance transactions into France. Lending into France out of London will presumably be more difficult; also, this may change the preference that has so far been given by parties to English law to govern the principal finance documents entered into by French borrowers in large financings, as – pending a new satisfactory treaty on mutual recognition of judgments between France and the UK – judgments from English courts on English law-governed documents will no longer be automatically given effect in France.[66]

65 Articles 231-13 and 231-18 of the AMF General Regulations.

66 In principle, a judgment obtained in the courts of another EU Member State and enforceable in that state will be recognised and enforceable in France without any special procedure being required, subject to and in accordance with Regulation (EU) No. 1215/2012 of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters.

Chapter 11

GERMANY

Andreas Diem and Christian Jahn[1]

I OVERVIEW

The recent developments in the European leverage loan market are reflected in the German local market: Although there is considerable liquidity in the market, the number of primary leveraged buyouts (LBOs) is quite limited. The total deal flow in 2015 was significantly higher than in the preceding year. However, more than half of this activity is attributable to refinancings rather than new money transactions. The market is dominated by refinancings and recapitalisations, but there has been a number of large-cap acquisitions and mid-cap LBOs are stable at a relatively high level. Large-cap transactions are typically financed with high-yield bonds, mid-cap acquisitions with bank debt from domestic banks (the majority of which are currently club deals). However, debt funds providing unitranche financings, as well as senior debt financings, have significantly grown in the German market in recent years. With respect to large-cap deals, in particular cross-border financings provided by institutional investors, but increasingly also by banks, covenant-lite terms are widely accepted. In the mid-cap market, conditions are more traditional. Most lenders require a leverage covenant (covenant-loose) and often even the full set of covenants. On the other hand, terms of low-leveraged deals have become more and more similar to corporate-style structures.

II REGULATORY AND TAX MATTERS

i Licensing requirements

The German Banking Act requires the authorisation of entities providing banking services. Authorisation (being licensed in Germany or 'EU passported') is generally required if an entity is conducting banking business in Germany commercially or on a scale that requires a commercially organised business undertaking.

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When it comes to foreign lenders, the practice of the German banking supervision is that such authorisation is not only required if a foreign lender operates permanent establishments or branches in Germany, but also if it turns to the German market from abroad in a targeted manner in order to repeatedly and in a businesslike manner or on a commercial basis (i.e., with the intention of a certain degree of regularity, not necessarily an intention to realise profits) provide financial and bank business in Germany;[2] however, a special authorisation is generally not required in the following cases:

a Reverse solicitation: a person or company established in the Federal Republic of Germany demands services on its own initiative from a foreign provider (non-solicitation exception). Note, however, that the distinction between reacting to an approach with a credit offer and taking executive action always requires an overall appraisal of all circumstances and must be analysed on a case-by-case basis.

b Acquisition of loans: the acquisition of loans is generally outside the scope of banking licence requirements. Note, however, that the restructuring of the loan after its acquisition may be deemed a regulated lending activity.

c Credit funds: pursuant to a legislative change that became effective on 18 March 2016, certain alternative investment funds (AIFs) and their managers (AIFMs) may originate loans within and into Germany if the loan origination forms part of their collective portfolio management (subject to certain requirements and restrictions).[3] AIFs not covered by this exemption have at least more flexibility with regard to the restructuring of loans. The exemption not only applies to German AIFs and AIFMs, but also to EU-AIFs and AIFMs and third-country AIFs and AIFMs (subject to a notification procedure that requires that the third country complies with the minimum standards of the AIFM Directive).

If none of the exceptions applies, the only way for the foreign lender to legitimitise cross-border lending transactions in Germany is to obtain an exception from the authorisation requirement.[4]

ii Taxes and fees

Generally, there are no withholding taxes payable on interest in Germany. The granting of security interests on German real estate is, however, subject to limited tax liability and may therefore trigger withholding tax on any interest payable for the secured loan (no matter where the grantor of security is domiciled). Furthermore, real estate transfer tax may be levied on the purchase price of real estate when enforcing a mortgage or land charge.

Under German law, the typical issue of achieving deductibility of interest expense of the acquiring entity against operating income of the target can be solved by way of a profit-and-loss pooling agreement between the two entities creating, given certain circumstances, a fiscal unit between them. Such fiscal unit causes the revenues of the controlled entity to be allocated

2 Section 32, paragraph 1, sentence 1 in conjunction with Section 1, paragraph 1, sentence 2, No. 2 of the German Banking Act.

3 Section 2 paragraph 1, No. 3b-d of the German Banking Act.

4 Section 2 paragraph 4 of the German Banking Act.

to the controlling entity when calculating corporate and trade taxes.[5] It should be noted, however, that the German law 'interest barrier' provides that deductibility of interest expenses exceeding interest revenues is generally limited to net interest expenses equal to 30 per cent of the relevant entity's earnings before interest, tax, depreciation and amortisation.[6]

There are no stamp duties or documentary taxes in connection with the execution and performance of facilities or security agreements under German law. The registration of land charges and mortgages with the land register will trigger a registration fee the amount of which depends on the value of the relevant security interest. A pledge over shares or partnership interests, or both, as well as the granting of a security interest over real estate and a submission to foreclosure in connection with the latter, will require the involvement of a notary and therefore trigger notarial fees. Their amount will also depend on the value of the underlying transactions.

When it comes to pledges over shares in a German limited liability company, there have been discussions around the validity of a notarisation of such pledge by a Swiss notary (which for some time has become quite common in practice in order to save fees). The German Federal Supreme Court (BGH) recently ruled that notarisation of a share transfer by a foreign notary is generally valid and binding if the function of that notary is equivalent to the German notary's function.[7] Under German law, the requirements for notarisation of pledges over shares follow the requirements for notarisation of their transfer. The BGH unfortunately did not clearly state that a notarisation by a Swiss notary fulfils that criterion.

iii Sanctions

Many non-German law-governed facilities agreements contain provisions relating to compliance with non-German sanctions that have extraterritorial reach, such as economic and trade sanctions based on US foreign policy and national security goals administered and enforced by the US Office of Foreign Assets Control (OFAC). If German entities are party to such agreements, German blocking legislation against extraterritorial aspects of OFAC sanctions must be taken into consideration. The German Foreign Trade Regulation[8] prohibits a German resident from complying with any sanctions that are foreign to Germany or the EU.

As a result, German companies (as borrowers, guarantors, etc.) must not give any confirmation as to their compliance with any non-UN, EU or German sanctions (including

5 Sections 14 et seq. of the German Corporate Tax Act and Section 2, paragraph 2, sentence 2 of the German Trade Tax Act in conjunction with Sections 14 et seq. of the German Corporate Tax Act. Fiscal units are also possible in relation to VAT and real estate transfer tax, but we have limited this overview to the most relevant forms of taxes.

6 Sections 4h German Income Tax Act in conjunction with Section 8a of the Corporate Income Tax Act.

7 BGH, resolution dated 17 December 2013, II ZB 6/13.

8 Pursuant to Section 7 of the German Foreign Trade Regulation, it is unlawful for any German-based person (e.g., borrowers, guarantors) to make a declaration to enter into or adhere to a trade boycott unless such trade boycott is in accordance with German, EU or UN sanctions. In addition, it is also unlawful for any (Germany or non-Germany based) person to request a Germany-based person to comply with trade boycotts that are not in accordance with German, EU or UN sanctions. The consequence of non-compliance is a misdemeanour carrying a fine of up to €500,000 and (under very limited circumstances) criminal liability.

OFAC), and German banks may not require compliance with such non-UN, EU or German sanctions (including OFAC) from any of its contractual counterparties (whether German or non-German). Appropriate carve-outs need to be included in the respective representations and undertakings. Alternatively, non-UN, EU or German sanctions-related clauses can be included in a side letter that is signed only by non-German parties to the transaction. Compliance with UN, EU and German sanctions regimes is permissible, so the relevant representations can be phrased accordingly.

III SECURITY AND GUARANTEES

i Types of security and guarantees

The German security regime does not provide for a global instrument granting collateral over substantially all assets of a person or entity (such as an English law floating charge). Substantially the same economic effect can be achieved by taking security over all the assets the relevant security grantor holds by way of implementing various security instruments, which generally are:

a pledges over shares and partnership interests;
b pledges over bank accounts, deposits and securities;
c security assignment of receivables (including trade receivables, intercompany and insurance receivables);
d security transfer agreements regarding moveable fixed assets and inventories;
e security over intellectual property rights (transfer, assignment or pledge); and
f security over real estate (mortgage, land charge).

Corporate guarantees are another common form of (third-party) security in Germany.[9]

ii Accessory or non-accessory nature of security

German security rights are either of an accessory or non-accessory nature. Accessory security (e.g., a pledge) is directly linked to a claim and can only be vested in a person that is itself a creditor, and only for the amount owed (presently or in the future) to that particular creditor. In contrast, non-accessory security is not linked to a claim, and can therefore also be vested in any third party holding such security on trust for the relevant creditors.

In syndicated credit facilities, non-accessory security rights are held directly by the security agent (i.e., title to the relevant right is directly conferred upon it). With respect to the very nature of accessory security rights, title in the relevant right can only be granted to the creditors of the secured obligations (i.e., all lenders and all other secured parties). In order to facilitate the granting and the transfer of accessory security rights together with the transfer of commitments of the secured facilities, it has become widespread practice in Germany to establish a 'parallel debt' in favour of the security agent, which takes the form of an abstract acknowledgment of debt, if contained in German law-governed documents, and which is equivalent to a 'covenant to pay'. This instrument is established either in the facilities agreement or in the intercreditor or security agency agreement, or created by a separate document. In any case, it creates an individual claim of the security agent that can

9 See Section III.v, *infra*.

itself be secured by the relevant accessory security rights and will remain with the security agent in the case of an assignment or transfer of commitments; however, currently, there are no clear court decisions on such instrument, which leaves some uncertainty in the market on whether this concept is legally valid and enforceable. Therefore, accessory security is often not only vested in the security agent by virtue of that parallel debt, but also granted directly to the other creditors (to secure their direct claims against the obligors).

iii Transfer and release of accessory or non-accessory security

If the underlying debt (i.e., the secured payment obligation) is transferred to a new lender acquiring a participation in a syndicated facility, attention should be paid to the continued existence of the relevant German law security rights. While non-accessory security rights will continue to exist even if transfers of the underlying debt take place by way of novation, accessory security rights will lapse by operation of law once the original secured claim ceases to legally exist. However, accessory security rights will remain in place and will follow the transfer of the underlying debt (in whole or in part) by operation of law if such underlying debt is transferred to a new creditor by way of assumption of contract or respective claims are assigned to a new creditor.

In the case of repayment or other discharge of the secured obligations, or both, non-accessory security rights need to be explicitly released, and rights transferred or assigned need to be re-transferred or reassigned to effect a full release. In the case of accessory security rights such as pledges, security rights will lapse by operation of law once the secured debt ceases to exist (and a release may be declared as a matter of record only).

iv Enforcement of security interests

With respect to the enforcement of security interests, different rules apply to accessory security rights, non-accessory security rights and security interests over real estate.

To enforce accessory security rights in the form of a pledge, certain statutory requirements need to be met. A pledge generally may only be enforced if the secured (payment) obligation has become due and payable,[10] and pledges over rights (e.g., account pledges, share pledges) theoretically require the pledgee to obtain an enforceable instrument[11] before it may enforce the pledges. However, the requirement of an enforceable instrument can be waived and in practice it is inevitably waived in the relevant security agreement. Accordingly, enforcement cannot be triggered by a 'simple' event of default (unless the relevant facilities agreement has been terminated and thus the obligations have become due and payable); nonetheless, any payment default relating to a repayment or prepayment requirement or the payment of interest or fees would be sufficient to commence enforcement.

To enforce non-accessory security rights (other than security over real estate) such as security assignments of receivables or security transfers of fixed and current assets, there is no legal requirement to obtain enforceable instruments, as title to the relevant assets has been transferred in full together with a contractual arrangement that the rights in the relevant asset may only be used for specific purposes upon the occurrence of specific events. The parties are – at least in individually negotiated security agreements – generally free to agree upon

10 Section 1228, paragraph 2 of the German Civil Code.

11 Section 1277 of the German Civil Code.

events that trigger enforcement rights of the secured party. Termination and acceleration of the facilities is not a prerequisite for enforcement of non-accessory security rights, although in practice the enforcement triggers negotiated for accessory and non-accessory security will almost always be the same.

Security rights over real estate, such as a mortgage as an accessory security right or a land charge as a non-accessory security right, may only be enforced upon prior receipt of an original enforceable instrument, and no waiver is possible in relation thereto. This is why normally, upon the establishment of the relevant security over the real estate in question, a submission by the owner to immediate foreclosure in relation to the amounts owed under the mortgage or land charge either solely of the encumbered real property or of all of the owner's assets is obtained.

Enforcement of security over encumbered assets may generally be achieved by way of sale or, in the case of monetary rights, by way of collection. In the case of pledges, the relevant assets need to be sold by way of public auction,[12] unless the assets have a value determined at a stock exchange or other determined market price[13] or, under certain circumstances and if the parties so agree once the security interest has become enforceable, by way of a private sale.

v Most relevant limitations on granting security interest

First-demand guarantees

There are two types of guarantees under German law: an accessory surety, the amount and validity of which depends on the underlying claim's amount and validity; and a non-accessory guarantee, the validity of which is not dependent on the underlying claim's validity.

Pursuant to a decision of the BGH,[14] a guarantee on first demand contained in any agreement may be invalid and unenforceable if such guarantee on first demand is contained in general business conditions within the meaning of Sections 305 et seq. of the German Civil Code. Even if not contained in general business conditions, such guarantee may, pursuant to German case law, only be given by companies experienced in international trade.

Concept of 'over-collateralisation'

German law provides for the concept of 'over-collateralisation', according to which the value of collateral granted for security purposes must not be 'excessive'.

If at the time of granting a security right either the value of the security right itself or its combination with other security rights is 'excessive', the relevant security will be deemed void (initial over-collateralisation). This is the case if there is a striking mismatch between the value of the security and the amount of the claims secured (taking into account not only the nominal value at stake but also the associated risk) so that the relevant arrangement taken as a whole (regarding its content and purpose) leads to a violation of the general rules of acting in good faith and fair dealings. Although several court decisions deal with various thresholds, there is no strict rule as to when exactly initial over-collateralisation has to be assumed. Generally, over-collateralisation will be assumed if the realisable value of the collateral exceeds 200 per cent of the secured obligations.

12 Section 1235 of the German Civil Code.

13 Section 1221 of the German Civil Code.

14 BGH, decision dated 23 January 1997, IX ZR 297/95.

Should over-collateralisation subsequently occur as a result of progressing repayment of the secured indebtedness or an increase of the value of collateral that has been granted on a revolving basis (such as an assignment of receivables), the security does not become void, but the grantor is entitled to a partial release of the security interest. The precedents are clearer on the applicable thresholds in the case of subsequent over-collateralisation than in the case of initial over-collateralisation. Generally, subsequent over-collateralisation is assumed if the realisable value of the collateral exceeds 110 per cent of the amount secured. The realisable value should be calculated at the time when the security provider requests the release of the security assuming an enforcement of the security interest in the collateral at that time. Pursuant to a resolution of the Grand Senate of the BGH,[15] the threshold for subsequent over-collateralisation is generally reached where the then-current market value (if there is one) or the purchase price or production costs (if there is no market value) of the collateral exceeds the secured obligations by 50 per cent.

Capital maintenance rules and financial assistance

While capital maintenance rules in general may apply (see below), a security grantor organised in the legal form of a German stock corporation is prohibited from giving financial assistance to the purchaser of its stock.[16] 'Assistance' in this context not only comprises granting direct loans or other means to acquire the relevant shares, but also extends to granting (upstream) guarantees and other (upstream) security for any indebtedness incurred in connection with the acquisition of its stock. In addition, a German stock corporation may not grant any benefits to its shareholders (or any affiliates of its shareholders) except for the payment of dividends from the annual profits of the stock corporation on the basis of a resolution of the general annual meeting of the shareholders.[17]

These prohibitions, however, generally do not apply if a domination or a profit-and-loss-pooling agreement is in place between the stock corporation and its (new) shareholders whose obligations are secured. The granting of a benefit to a shareholder is permitted to the extent the stock corporation has a fully recoverable claim for true consideration or repayment against that shareholder.[18]

While financial assistance prohibitions strictly apply to German stock corporations only, capital maintenance requirements need to be observed by both stock corporations and limited liability companies, while within limited partnerships, the applicable capital maintenance regulations are those applying to its general partner. As outlined above, the shareholders of a stock corporation may generally not receive any benefit from the relevant stock corporation other than dividends, and the repayment of capital to the shareholders is prohibited. The provisions applicable to limited liability companies are somewhat less stringent and only prohibit payments to the shareholders to the extent that such payments cause the net assets of the company to fall below its registered share capital or, if the amount of net assets is already below the amount of the registered share capital of the company, to cause such amount to be further reduced.[19] It is acknowledged that these prohibitions not

15 BGH, resolution dated 27 November 1997, GSZ 1 u. 2/9

16 Section 71a of the German Stock Corporation Act.

17 Section 57 of the German Stock Corporation Act.

18 Section 57 of the German Stock Corporations Act.

19 Section 30 of the German Limited Liability Companies Act.

only relate to direct cash payments, but also to any other benefits for the shareholders (or their affiliates), including the granting of security rights to any third parties that are lending to or have other payment claims against the relevant shareholders or affiliates.[20] As in the case of stock corporations, there are also exceptions for scenarios where a domination or a profit-and-loss-pooling agreement between the limited liability company and its shareholders is in place or the limited liability company has a fully recoverable claim for true consideration or repayment against its shareholders.[21]

While an entity that grants security interests or even payments in breach of these obligations is entitled to a repayment of the relevant benefit from its shareholders or affiliates, the directors of the disadvantaged entity themselves, in certain specific instances, may face personal – and in certain cases even criminal – liability.

A violation of the capital maintenance rules and limitations on financial assistance does not generally or *per se* render a guarantee or other security interest granted to a third-party lender void. However, even if one of the above-mentioned exceptions might apply, it is market practice to provide for appropriate limitation language in relation to the liabilities of a German subsidiary having granted a guarantee or asset security, or both, for its direct or indirect shareholders taking into account, to the extent applicable, the relevant prohibitions and the legal exceptions (e.g., for domination agreements). The details of such limitation language are usually discussed in detail and at length.

Prohibited encroachment

In addition to capital maintenance requirements, court decisions and jurisprudence have also developed the concept of prohibited encroachment on the security grantor's vital financial means. According to this concept, a shareholder is prohibited from extracting funds from a debtor where such funds are required to maintain the debtor's liquidity. The concept has led to a threat of liability of the shareholders in relation to the company. Thus, a debtor may hold its shareholders liable for causing its over-indebtedness or illiquidity. It cannot be ruled out that a third-party creditor may also be held liable for aiding and abetting such prohibited encroachment if both the relevant shareholder and the relevant third-party creditor acted intentionally. Therefore, in special circumstances German courts may determine that a security grantor providing upstream guarantees or asset security for its shareholders may have a valid defence or counterclaim against the claims of a third-party creditor.

vi Avoidance of security interest in an insolvency

In the case of an insolvency administration, security interests may be impacted by an avoidance of the creation of such rights by the insolvency administrator. Such administrator may challenge and therefore avoid any security interest granted over the assets, *inter alia*, if:

a such security has been granted or effected within three months prior to the filing for insolvency if the debtor was illiquid at the time of the transaction and the creditor had knowledge of such illiquidity or of the relevant facts that support a compelling conclusion with respect thereto, and the granting of such security has either resulted in, or put the creditor in a position to obtain or seek, security or satisfaction; or directly results in the deterioration of the position of other creditors;

20 See Diem, *Akquisitionsfinanzierungen*, 3rd edition, Section 43 No. 4, for further examples.

21 Section 30 of the German Limited Liability Companies Act.

b such security has been granted or effected subsequent to the filing of the insolvency petition if the creditor had knowledge of the illiquidity or of the relevant facts that supported a compelling conclusion with respect to such illiquidity and the granting of such security has either resulted in, or put the creditor in a position to obtain or seek, security or satisfaction; or directly results in the deterioration of the position of the creditors;

c such security has been granted or effected during a period of one month prior to, or subsequent to, the filing of the insolvency petition and has resulted in, or has put the creditor in a position to obtain or seek, security or satisfaction to which the creditor is not entitled either at such time or at all;

d such security has been granted or effected during the second or third month prior to the filing of the insolvency petition and has resulted in, or has put the creditor in a position to obtain or seek, security or satisfaction to which the creditor is not entitled either at such time or at all, where the debtor was insolvent at the time of such transaction or the creditor had knowledge at the time of such transaction that the transaction would have adverse effects on the ordinary creditors of the debtor, or the creditor had knowledge of the relevant facts that supported a compelling conclusion with respect to such effect; or

e such security has been granted or effected during a period of 10 years prior to, or subsequent to, the filing of the insolvency petition if the debtor had the intention to adversely affect the position of its other creditors and the respective creditor had actual knowledge of such intention (such knowledge being assumed under certain circumstances).[22]

Note, however, that the risk of avoidance of security interests can be significantly reduced if structured in the form of a cash transaction (i.e., the grantor – or an affiliate in the business of which the grantor has a reasonable interest – received an arm's-length benefit in exchange for and together with or immediately after the granting of security). In such case, the security can only be avoided based on the criteria outlined under (e) above.[23]

IV PRIORITY OF CLAIMS

i Contractual arrangements for ranking of security

In cases where several layers of debt and different classes of creditors are to be secured by identical assets, the distinction between non-accessory and accessory security plays an important role. While rights under non-accessory security are usually conferred to one beneficiary only and there is no creation of a second ranking right in the same asset (e.g., assignment of receivables to the security agent in order to secure various groups of creditors), accessory security rights can be conferred to different groups of creditors in subsequent ranking (e.g., first-ranking pledges, second-ranking pledges). The same holds true for the non-accessory right of land charges over German real estate, which can be granted in subsequent ranks.

22 Sections 130 to 133 of the German Insolvency Code.

23 Section 142 of the German Insolvency Code.

While it is usual practice that non-accessory security rights are conferred upon a security agent, with contractual provisions in intercreditor documentation regulating the waterfall for distribution of proceeds from enforcement of such security rights among the different creditor groups, practice varies in the case of accessory security rights. Quite often, first-ranking security rights are created for senior secured creditors, with separate second-ranking security rights for a creditor group ranking behind the first-ranking lender group, etc. In order to minimise documentation and effort for the security grantor, it is also not unusual for the creditor groups to agree to create only one accessory security right for all of them collectively within the same rank, and then agree to the distribution waterfall in the relevant intercreditor document, which would be applicable to non-accessory security rights and for general purposes anyway.

ii Impact of the German insolvency regime on secured creditors

After a petition for insolvency has been filed, it may take several weeks for formal insolvency proceedings to be commenced and a final insolvency administrator to be appointed. In the mean time (i.e., during the preliminary insolvency proceedings), the court may – and usually will – grant a moratorium, which prohibits any disposal of assets by the debtor (including its creditors). Hence, such creditors, even if they hold title to assets subject to collateral, may not enforce their security interest themselves during that period, but will need to rely on the preliminary administrator to enforce the collateral.

Generally, the administrator will have to realise any assets that belong to the debtor's estate unless otherwise resolved by the creditors' meeting and provided that the insolvency administrator has a respective realisation right pursuant to the German Insolvency Code (see below). Realisation may not only be implemented by the sale of individual items of the company's property, but also through the sale of the company's business as a whole or in part.

In selling the company's property, special treatment is required for items that are subject to rights of separation and recovery[24] or preferential rights.[25] Any right *in rem* or personal right under which the debtor may claim that the item in question does not belong to the estate involves the right to separate that item from the estate. The relevant creditor may require that items that are subject to a right of separation be surrendered out of the estate, and such items may not be realised by the insolvency administrator.

In contrast, any preferential rights such as real estate mortgages, pledges over moveable assets and rights, transfers by way of security and assignments by way of security do not involve a claim for surrender out of the estate but only a claim for preferential satisfaction of the respective creditor's claims when realising the asset to which the preferential right refers. In the course of preliminary and formal insolvency proceedings, the beneficiaries of security are entitled to receive the full amount of the proceeds from their enforcement without, generally, the need to share these proceeds with other creditors. However, the formal insolvency administrator will, where it has the right to enforce the security, deduct the costs of the realisation consisting of, generally, ascertainment costs (4 per cent) and realisation costs (5 per cent) plus taxes (VAT), if applicable, from the realisation proceeds. This does not apply, *inter alia*, to the enforcement of pledges over

24 Section 47 of the German Insolvency Code.

25 Sections 49 to 51 of the German Insolvency Code.

shares or partnership interests, as the formal insolvency administrator does not have a right to enforce the security. Any realisation surplus remaining after satisfaction of any party holding a preferential right will be allocated to the debtor's estate.

iii Equitable subordination of shareholder loans

Under German law, shareholder loans are subordinated in a debtor's insolvency.[26] The former prerequisite of a financial crisis during which the loan was granted or not recalled has fallen away since 2008, as have former repayment restrictions outside insolvency proceedings. Thus, prior to an insolvency, a shareholder loan may be repaid at any time, and generally no restrictions apply. However, once insolvency proceedings have been commenced, all shareholder loans become automatically subordinated to other creditors' claims, while repayments of any shareholder loans within a claw-back period of one year immediately preceding the application for the opening of insolvency proceedings are subject to avoidance,[27] regardless of whether such repayment prior to insolvency occurred in a financial crisis or otherwise.

In a ruling by the BGH in 1992,[28] third parties were treated as quasi-shareholders (and therefore subordinated creditors in its debtor's insolvency) if they had a 'shareholder-like influence' on the company. The decision related to a savings institution that held pledges in its borrowers' shares, and in addition had massive contractual and factual influence over the management of the borrower group. Following this decision, it has become controversial whether financial institutions that, for example, through tight covenants deal with questions that are typically dealt with by shareholders, could be treated as quasi-shareholders by German courts and therefore become equitably subordinated in the borrower's insolvency. It is therefore important that covenants provide sufficient flexibility to the borrower to manage its day-to-day business without the requirement of prior approvals by the lenders. It is also often provided that certain covenants are not directly applicable to German obligors, but only indirectly by way of information undertakings relating to actions otherwise prohibited by the respective covenants and a determination right for lenders whether such actions would have material adverse consequences for the lenders' risk or security position. There are, however, no court decisions relating to such 'restrictive covenants', and a court will likely make its decision based on an overall view of not only the documentation, but also the factual influence of lenders.

V JURISDICTION

A foreign choice of law clause in loan and security agreements is generally recognised and applied by German courts. Inside the EU, the recognition and effect of a choice of foreign law relating to contractual obligations is subject to the provisions of Rome I[29] and to German public policy.

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26 Section 135 of the German Insolvency Code.

27 Section 135 of the German Insolvency Code.

28 BGH, decision dated 13 July 1992, II ZR 251/91.

29 Regulation (EC) No. 593/2008 of the European Parliament and of the Council on the law applicable to contractual obligations.

The recognition and effect of a choice of law provision relating to non-contractual obligations will be subject to Article 14 of Rome II[30] and to German public policy.

German private international law mandatorily provides for the *lex rei sitae* principle to apply to all rights *in rem*.

VI ACQUISITIONS OF PUBLIC COMPANIES

German stock corporations are governed by the German Stock Corporation Act, and transactions on the German capital market are governed by the German Securities Trading Act and the German Securities Acquisition and Takeover Act. Compliance with provisions contained in these laws is supervised by the German Financial Services Supervisory Authority (BaFin).

When someone directly or indirectly acquires control over (i.e., at least 30 per cent of the voting rights in) a publicly listed company, a tender offer for all outstanding shares in that company is mandatory.[31] The 30 per cent threshold is calculated including shares held by subsidiaries and persons acting in concert. The offer needs to include a fair consideration (usually at least the average stock exchange trading price during the three months before gaining control). The tender offer needs to be filed with and approved by BaFin. In financing scenarios, this requirement is of particular relevance when it comes to an enforcement of pledged shares in a public company. An acquisition of stock in that context triggers the mandatory offer requirement in the same way as any other acquisition. The pledge of shares itself does not, however, trigger a respective duty.

Regarding public offers (whether mandatory or voluntary), German law[32] requires a bidder to ensure, prior to publishing the offer document, that it has the means necessary for fully performing the offer at its disposal at the time that the claim for consideration becomes due and payable. Where the offer provides for a consideration in cash, an independent investment services enterprise shall confirm in writing that the offeror has taken the steps necessary to ensure that the means required to perform the offer in full are available at the time at which the claim for cash payment becomes due and payable ('financing confirmation').

If the bidder has not taken the steps necessary for these purposes, and if for that reason it does not have the necessary means at its disposal at the relevant time, the person who has accepted the offer may claim from the investment services enterprise compensation for any damage incurred as a result of the incomplete performance. The investment services enterprise is, however, only liable for gross negligence and wilful misconduct.

It is controversial whether the term 'necessary means' includes means for the refinancing of the target company's existing liabilities. The requirement to take 'necessary steps' is generally fulfilled with the signing of the loan agreement. It is, however, controversial whether and to what extent termination rights and conditions precedent to utilisation of the loans may be included in the loan agreement. Most legal authors only require a waiver

30 Regulation (EC) No. 864/2007 of the European Parliament and of the Council on the law applicable to non-contractual obligations.

31 Section 35 of the German Securities Acquisition and Takeover Act.

32 Section 13 of the German Securities Acquisition and Takeover Act.

of ordinary termination rights. Conditions precedent and extraordinary termination rights (e.g., after the filing of a petition for insolvency) are permitted according to those legal authors. Material adverse change clauses are also controversial.[33]

According to certain legal authors and to the practice of BaFin, the financing confirmation must not contain any conditions. According to other authors, conditions that are permitted in voluntary public offers[34] may also be included in a financing confirmation. Mandatory public offers must not contain any conditions, except for outstanding permits by authorities such as merger clearance.

VII OUTLOOK

The European Union has recast the European Insolvency Regulation, which will apply to insolvency proceedings within the European Union from 26 June 2017 onwards. The recast regulation, *inter alia*, provides for rules governing pre-insolvency proceedings, secondary proceedings and group insolvencies.

33 For more detail, see Diem, *Akquisitionsfinanzierungen*, 3rd edition, Section 11 No. 26.

34 Section 18 of the German Securities Acquisition and Takeover Act.

Chapter 12

INDIA

Justin Bharucha[1]

I OVERVIEW

Leveraged finance in India has not evolved to the extent that it has in western jurisdictions. Lending against security or security interests created over assets is, of course, common; lending for the purpose of the acquisition of shares[2] and lending against security or security interests created over shares are regulated and, in some cases, prohibited. Companies[3] are prohibited from 'assisting' with the acquisition of their own shares, effectively precluding leveraged buyout (LBO) structures, and, separately, banks and non-banking financial companies (NBFCs)[4] are subject to caps on their exposure to transactions where the principal security[5] or collateral comprises shares.

Regulatory restrictions also prevent Indian acquirers from utilising foreign currency loans such as foreign currency convertible bonds (FCCBs) and external commercial borrowings (ECBs) to finance domestic acquisitions.

There are some exemptions to the rigour of this regime; for example, lending to the infrastructure sector is incentivised, and market participants are increasingly aware of the ease of structuring leveraged transactions in other jurisdictions. It is telling that market-leading

1 Justin Bharucha is a founding partner at Bharucha & Partners.

2 'Shares' refers to securities issued by companies. In most cases, promoters seek to use their equity or quasi-equity shareholding as collateral for a facility.

3 Indian company law prevents only public, both listed and unlisted companies, from providing 'financial assistance' for acquisition of any shares in the company or in its holding company.

4 An NBFC is a company that acts as a financial institution or as a non-banking institution whose principal business is receiving deposits or lending. The government may, from time to time, classify other companies as NBFCs.

5 'Security' includes collateral.

Indian investments in other jurisdictions have been successfully structured using leveraged finance, such as the Tata Steel acquisition of Corus for nearly £6 billion and the UB Group acquisition of Whyte & Mackay.

II REGULATORY AND TAX MATTERS

i Regulatory matters

There are distinct regulatory concerns that must be considered by borrowers, other obligors and lenders in India. Some of these are of general application, while some apply only, and additionally, to transactions where the borrower or the lender is not Indian.

Indian borrowers

Leveraged buyouts

Leveraged buyouts by public companies[6] are not permitted under the Indian company law, which prevents a company from providing assistance to facilitate the acquisition of its shares. Therefore, acquirers of a company cannot raise funds using the assets of the Indian target company (public company) as security for such financing.[7] While this stricture does not apply to private companies, leveraged buyouts are rare, although slowly gaining ground.

Indian subsidiaries of foreign companies

Foreign direct investment (FDI) in India, both primary subscription and secondary acquisition, is permitted without prior approval from the Foreign Investment Promotion Board or the Reserve Bank of India (RBI) subject to compliance with conditions, including those relating to sectoral caps and pricing. FDI is a preferred route for raising funds for M&A transactions as, unlike in the case of ECBs, there are no restrictions on the end use of funds.

An alternative available to non-resident investors seeking to secure leveraged finance in India may be to secure leveraged finance at a level above the Indian target company (i.e., the offshore acquirer secures finance from lenders offshore India to make the acquisition). While a non-resident investor may encumber shares of the relevant Indian company to secure credit facilities raised outside India, prior RBI approval is required if the proceeds of such credit facilities are to be used for further acquisition in India[8] and such approval is not forthcoming.

Indian obligors

Indian Company Law

The Companies Act 2013 (Companies Act) restricts, *inter alia*, a company's ability to provide loans and guarantees. This, however, may be addressed by seeking specific shareholder approval to provide guarantees in excess of the limits specified under the Companies Act.

Additionally, an Indian company cannot provide loans to, or provide guarantees in respect of, loans availed by:

6 Section 67(2) of the Companies Act, 2013

7 The only exception is a buy-back of the company's shares in accordance with the Companies Act 2013, but this is not germane to this chapter.

8 Regulation 12(iv) of the Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations 2000

a its directors or persons in whom its directors are interested (persons in whom a 'director is interested' include private companies of which he or she is a director or shareholder); Indian companies are also prohibited from providing loans for, or guarantees on behalf of, directors of their holding companies; and

b its holding company.

Indian foreign exchange regulations

The Indian rupee is not freely convertible, and the Foreign Exchange Management Act 1999 and the rules and regulations prescribed thereunder prescribe restrictions on transactions between Indian residents and foreigners. The prior approval of the RBI is required for granting security over assets in India in favour of offshore lenders. There are, however, certain exceptions:

a an Indian company may provide security over assets in India in favour of a foreign lender to secure an ECB subject to certain conditions.[9] However, Indian banks and NBFCs cannot guarantee or secure ECBs on behalf of Indian borrowers; and

b Indian companies may also provide guarantees to secure loans availed of by their overseas subsidiaries or joint venture companies provided that certain conditions are met.[10]

Indian lenders

To uphold the integrity of the domestic banks, the Banking Regulation Act 1949 prohibits banks from granting loans and advances against security of their own shares. Additionally, banks are not permitted to provide loans or advances to their directors or entities in which their directors are interested. The RBI has also prescribed credit exposure norms in respect of individuals, groups, certain industries and sectors, and the capital market. The exposure of Indian banks to capital markets is regulated, and vanilla lending for buying shares of an Indian company by banks is not permissible.

Banks

The RBI has prohibited banks from lending monies to a borrower company (offshore or onshore) if the funds are to be used to purchase shares of an Indian company. However, banks may lend monies to Indian companies for acquisition of equity in overseas joint ventures, and, or, wholly owned subsidiaries or in other overseas companies as strategic investment. [11]Further, foreign currency loans, including the proceeds of ECBs, cannot be availed for onshore acquisitions. The underlying reason for the prohibition is to ensure the safety of domestic banks and to prevent volatility in the Indian security markets due to offloading of shares.

9 For example, the guarantor should have received a no objection certificate from its authorised dealer bank; if security is given over immoveable assets, the charge should be coterminous with the ECB.

10 An Indian entity may do so only if the aggregate financial commitment to all its overseas subsidiaries and joint ventures does not exceed 400 per cent of the Indian company's net worth.

11 Paragraph 2.3.1.12 of the RBI Master Circular on loans and advances dated 1 July 2015.

As they are for NBFCs, exposure norms are prescribed for banks;[12] what is germane is that, generally, a bank cannot hold more than 30 per cent of the capital of another company or shares whose value exceeds the higher of 30 per cent of its own paid-up capital and reserves. A bank's aggregate exposure to the capital markets (both fund-based and non-fund based) should not exceed 40 per cent of its net worth at the end of the previous financial year. Within this overall ceiling, the bank's direct investment in shares, convertible bonds or debentures, units of equity-oriented mutual funds and all exposures to venture capital funds (both registered and unregistered) must not exceed 20 per cent of its net worth.

A bank cannot provide a loan in excess of 1 million rupees to an individual against security of shares, convertible bonds, convertible debentures and units of equity-oriented mutual funds where the securities are held in a physical form and are worth in excess of 2 million rupees where the securities being pledged are dematerialised. Such loans would be considered part of a bank's exposure to capital markets.

Loans sanctioned to corporates against the security of shares for meeting the promoters' contribution to the equity of new companies in anticipation of raising resources will be treated as a bank's investments in shares, which will fall under the 40 per cent ceiling of the bank's net worth as at the end of the previous financial year. These loans will also be subject to individual or group of borrowers' exposure norms, as well as the statutory limit on shareholding in companies.

NBFCs

An NBFC is a company whose financial assets constitute more than 50 per cent of its total assets, and over 50 per cent of its gross income is attributable to the income from such financial assets. Unless specifically exempted, every NBFC is required to be registered with the RBI.

Historically, apart from the general prudential regulations applicable to all NBFCs, lending against shares by NBFCs was not subject to any specific regulatory restrictions. Unfortunately, acquirers still face difficulties in financing high-value transactions, as NBFCs are subject to exposure norms that apply to business sectors, single borrowers and affiliated companies.

In addition, the RBI recently restricted NBFCs from lending against a pledge of shares in an attempt to control the market volatility caused by the invocation of pledges in an event of default. Consequently, NBFCs are now required to, *inter alia*, maintain a loan-to-value ratio of 50 per cent.

Additionally, NBFCs with assets worth 1 billion rupees or more can only accept shares as security if such shares have been traded on a stock exchange for a specific number of days in the preceding 18-month period. The new norms for NBFCs lending against shares are also aimed at ensuring that NBFCs are not overleveraged.

12 Banks' exposure limits for individual borrowers is 15 per cent of the capital funds and 40 per cent for group borrowers subject to an increase of 5 per cent in the case of individual borrowers, and 10 per cent in the case of group borrowers where credit is being given for infrastructure projects and a separate increase of 5 per cent if the borrower consents to the bank disclosing such exposure in its annual report.

The exposure of a bank to a single NBFC should not exceed 10 per cent of the bank's capital funds or 15 per cent of the bank's capital funds in the case of an asset finance company.[13] These limits may be increased by 5 per cent where the funds are on-lent to the infrastructure sector.

Offshore Indian lenders

Indian companies can access funds from abroad through ECBs by way of commercial loans and issues of FCCBs, non-convertible, optionally convertible or partially convertible preference shares and foreign currency exchangeable bonds (FCEBs). FCCBs and FCEBs are subject to several conditions (limits on the tenure, amount of the loan, use of funds, rate of return, etc.).

ECBs cannot be raised to finance acquisitions of (other) Indian companies.

Offshore subsidiaries and joint ventures

Indian companies are permitted to establish offshore Indian joint ventures and subsidiaries and issue guarantees securing obligations of those joint ventures and subsidiaries (see above); however, no such joint venture or subsidiary may hold shares of an Indian company and are therefore relevant only for an Indian company that seeks to make further acquisitions outside India.

Foreign institutional lenders

Foreign institutional investors (FIIs) are entities incorporated outside India, and registered with the Securities and Exchange Board of India (SEBI), that invest in India securities. Although not 'lenders' *per se*, FIIs may subscribe to debt. Presently, there are over 1,450 FIIs registered with SEBI.

As rated securitisation transactions allow for structuring of risk-return profiles, there is no shortage of investors looking to participate. Other debt market products, however, such as non-convertible debentures (NCDs) and commercial paper, are typically acquired by FIIs, microfinance-focused funds and other impact investors, and some of these debt instruments may be secured.

ii Tax matters

The RBI has mandated that all authorised dealers[14] through whom foreign exchange transactions are carried out are responsible for complying with the applicable tax laws.

Interest payments are subject to withholding, and service tax is levied on arrangement and similar fees.

In addition, where a company has guaranteed the obligations of another, affiliate, company at no charge, the Indian Revenue requires the guarantor to pay tax on a deemed income (a percentage of the guaranteed amount calculated broadly at par with bank charges for an equivalent guarantee) that the guarantor would have received for issuing a third-party guarantee. This is currently subject to challenge, but it is an important issue to bear in mind while analysing transactions.

13 A type of NBFC.

14 The Indian bank remitting the monies outside India.

III SECURITY AND GUARANTEES

i Types of security and guarantees

The securities and guarantees that can be issued in favour of the lender are as follows.

Shares

Shares of both listed and unlisted companies may be pledged by executing a duly stamped deed of pledge.

Under the SEBI (Substantial Acquisition of Shares and Takeover) Regulations 2011 (Takeover Regulations), an encumbrance created over shares of a listed company by a promoter must be disclosed to the target company and the stock exchange on which the target company is listed.

If the enforcement of pledge results in the lender holding more than 25 per cent of the capital of the listed company, the lender will be obliged to make an open offer in terms of the Takeover Regulations; however, if certain conditions are met, the invocation of pledge by a scheduled commercial bank or a public financial institution will not trigger an open offer.

Immoveable property

Mortgage of immoveable property is usually by way of a registered mortgage deed or by deposit of title deeds. Depending on where the property is situated and nature of the property to be mortgaged, approvals from the government or local authorities may be required. Additionally, where the property has been leased, the approval of the lessor or lessee will also be required for the creation of a mortgage.

Moveable property

Security may be created by way of hypothecation over moveable property through deeds of hypothecation. The charge has to be registered with the registrar of companies (RoC). Moveable property generally includes all forms of tangible moveable property, such as portable machinery and equipment, cars, financial instruments such as shares, debentures, claims and receivables such as trade-related receivables, contractual rights and benefits, and intellectual property such as trademarks. Security interest can be created over tangible property with a fixed or floating charge and by way of a floating charge on fungible assets such as inventory and stock in trade. Charge is created over cash and bank accounts in a similar manner through deeds of hypothecation.

Guarantees

Guarantees may be obtained from the borrower or the onshore corporate promoters, or both, or their associates. Generally, a guarantee that is offered to secure an acquisition financing consists of a corporate guarantee or a promoter guarantee of acquirer, or both.

NBFCs

Although security interests can be created in favour of an NBFC, enforceability of such security interests remains a challenge. Enforcement of security interests over immoveable property is usually a time-consuming and court-driven process. Unlike banks, NBFCs are not entitled to security interests under the provisions of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002.

Enforcement of security

Under most financing documents, situations such as shareholder or promoter misrepresentation, changes in the debt-to-equity ratio, falls in profits after acquisition, etc., are held to be events of default. In such situations, lenders typically retain the right to enforce security.

Under Indian law, however, an amount must be overdue to the lenders prior to enforcement; therefore, ordinarily lenders accelerate the debt and thereafter enforce the security interests. Enforcement of security against a liquidator or creditor of the borrower prior to insolvency will be void if the requisite forms with the RoC have not been filed or if the lender does not file a suit for recovery within three years of the date the debt was due or acknowledged by the company.

It should also be noted that banks may enforce security more easily than an NBFC, and this results in a higher cost to the borrower where the lender is an NBFC.

IV PRIORITY OF CLAIMS

The Companies Act 1956 provides that in the event of winding up, certain payments rank in priority over others. Such claims include workmen's dues and debts due to secured creditors (to the extent such debts rank *pari passu* with workmen's dues). At the time of winding up, these claims are to be paid prior to all other claims. Such debt will also have priority over the claims of debenture holders under any floating charge created by the company and must be settled out of proceeds of any property comprised in or subject to that charge.

All statutory dues payable to the government or local authorities, wages owing to employees[15] and employment benefits accruing to employees in the year prior to winding up will rank *pari passu* with workmen's dues and amounts payable to secured creditors. In the event that the assets are not sufficient to meet these preferential debts fully, they abate or are reduced in equal proportion.

Subordination of debt may take place either in terms of statute (see above) or contractually. Lenders can contractually determine priority and subordination. Where the priority of security is not contractually agreed, security that is created prior in time will rank in priority to security that is created later. Lenders may even contractually agree among themselves and determine the ranking of their debts. An intercreditor agreement generally spells out the differences between different creditors and their rights in the event of a bankruptcy or default of the borrower. A first-ranking charge will have priority over a second-ranking charge at the time of enforcement of security.

It is important to mention that Indian company law is in a state of flux, and the Companies Act 1956 is being replaced by the new Companies Act. The provisions of the Companies Act relating to winding up have not yet come into force, however; they are, in any event, largely consistent with the provisions of the Companies Act 1956 in this regard.

15 In the Indian legal context, there is a distinction between 'workmen' and 'employees'. A 'workman' is a person other than a person employed in a supervisory capacity drawing wages exceeding 10,000 rupees per month or exercising, either by the nature of duties attached to his or her office or by reason of the powers vested in him or her, functions mainly of the managerial nature; or a person employed mainly in a managerial or administrative capacity. All other persons employed by an establishment would be considered 'employees'.

V JURISDICTION

The Supreme Court of India has recognised the right of parties to select the law governing a contract as long as such choice is *bona fide* and legal. That said, it is extremely rare for Indian loan documentation to be governed by any law other than Indian law. A foreign law is usually stipulated as applying to loan documents where the loan is not rupee-denominated or the lender is a non-resident.

Under the Civil Procedure Code 1908, a certified copy of a decree of any of the superior courts of a reciprocating territory may be executed in India as if it has been passed by an Indian court. The Indian court must, however, refuse execution of any such decree in certain circumstances, for example, when the judgment has not been made by a court of competent jurisdiction or the judgment is not on the merits. The Supreme Court of India has affirmed this on more than one occasion. A party seeking to enforce a foreign judgment in India may be required to obtain approval under the applicable foreign law to execute such a judgment or to repatriate any amount recovered.

Arbitration provisions governed by rules other than the Indian Arbitration and Conciliation Act, 1996 (Arbitration Act) are common in financing documents. Enforcement of a foreign arbitral award in India is possible under the Arbitration Act, which recognises awards made in countries with which India has a reciprocal relationship. That the courts cannot go into the merits of the award was clearly laid down by the Supreme Court in *Renusagar Power Co Ltd v. General Electric Co*.[16] Indian courts may refuse to enforce foreign awards on certain grounds (e.g., if the arbitration agreement is not valid under the law to which it is subject or if the award contains decisions on matters not submitted to the arbitral tribunal). The courts may also refuse to enforce a foreign award if, in the opinion of the court, the enforcement of the award would be contrary to India's public policy. This reasoning has been used fairly liberally by Indian courts in the past.

The enforcement of documents governed by foreign law is generally subject to the nature of remedies available in Indian courts, the acceptance by such courts of jurisdiction, the powers of such courts to stay proceedings, and other principles of law and equity and procedure of general application. Enforcement may also be affected by failure to take timely action or the lapse of time, which may operate as a bar on further judicial proceedings under the provisions of the Indian Limitation Act 1963.

VI OTHER MATTERS

With the slowdown of the Indian economy impacting a number of projects and companies, the RBI has started paying greater attention to stressed assets. In its discussion paper, 'Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair Recovery for Lenders: Framework for Revitalising Distressed Assets in the Economy' dated 17 December 2013, the RBI proposed major changes to the framework for restructuring stressed assets. Taking into account the comments received, the RBI issued the 'Framework for Revitalising Distressed Assets' dated 30 January 2014, which came into effect on 1 April 2014 (Framework). The Framework contemplates changes that could possibly result in regulations that permit LBOs of non-performing assets or financially stressed companies by specialised entities.

16 AIR 1994 SC 860.

Banks would be required to ensure that these entities are funded. Currently, banks are not permitted to finance acquisition of a promoter's stake in a company, since the RBI is of the firm view that promoters should acquire an equity stake through their own resources and not through borrowing. Additionally, the RBI proposes to permit banks to extend finance to specialised entities established for the acquisition of stressed companies; however, the RBI is yet to formally implement a comprehensive legal framework. The proposed changes, once implemented, are expected to encourage global acquisition firms to participate in the process of restructuring stressed Indian companies, and to lend their management expertise in addition to providing funding.

Infrastructure finance companies (IFCs) and infrastructure debt funds are NBFCs exclusively financing the infrastructure sector. Some of these companies have asset books running into millions of rupees and are experts in long-term project financing. The asset liability pattern, however, is a matter of concern in the case of IFCs, as these are lending long term against comparatively shorter-term liabilities.

Many microfinance institutions are actively involved in raising debt finance from capital markets via the issuance of NCDs, commercial paper, unsecured subordinated NCDs and through rated securitisation transactions or portfolio buyouts in which banks routinely invest. NBFCs also provide funding in the form of NCDs without being subjected to the interest-rate caps that apply in the case of compulsory convertible debentures.

Listed NCDs can be secured (by way of pledge, mortgage of property, hypothecation of receivables, etc.) in favour of the debenture trustee that acts for and in the interest of the NCD holders. The RBI has established a framework for investments that allows foreign portfolio investors (FPIs) to take part in open offers, buyback of securities and disinvestment of shares by the central or state governments. While, for the most part, borrowing of monies from outside India is heavily regulated with restrictions on end use, NCDs may be issued to FPIs with relative ease, as no approvals from the RBI are required and compliance with the ECB guidelines is not required.

We anticipate the past practices to see significant changes in light of the change in regulatory position that will result in an increase in the number of transactions over the next few months.

Chapter 13

ITALY

Andrea Novarese and Marcello Bragliani[1]

I OVERVIEW

The Italian banking market remains subject to significant limitations applying to intermediaries and investors who might be interested in investing resources and extending loans to Italian borrowers. However, most recently the Italian legislator has taken some steps intended to soften the general requirements of a banking licence and open the possibility for capital market investors and intermediaries to invest and benefit from security typically reserved for banks.

II REGULATORY AND TAX MATTERS

i Licensing and regulatory aspects

Unlike a number of other EU countries, Italian law classifies lending activity, even if not conducted in connection with the taking of deposits from the public, as a restricted one. As a result, any person performing lending activity on a professional basis in Italy must be an authorised bank or financial intermediary. Non-Italian banks can lend under the following conditions: (1) non-EU banks can lend directly in Italy provided that they have obtained authorisation from the Bank of Italy, and (2) EU banks and financial institutions can lend in Italy under the right of establishment or free provision of services regime, provided that they have been properly authorised in their country of origin under the 'passport regime'. In addition, Law Decree No. 91/2014 (Decree 91), aimed at setting out measures for economic growth, introduced significant changes that increased the number of institutions permitted to engage in lending activity. As a result of these changes, Italian insurance companies, SACE SpA, Italian securitisation vehicles (Law 130 SPV), Cassa

1 Andrea Novarese and Marcello Bragliani are partners at Latham & Watkins LLP. Special thanks to Maria Cristina Storchi, partner at Latham & Watkins LLP, for her assistance with reference to section VI 'Acquisitions of public companies' and to Davide Camasi for his help.

Depositi e Prestiti SpA[2] and certain EU credit collective investment institutions are now also authorised to exercise lending activity; however, it should be noted that several key elements of Decree 91 need to be interpreted in light of the relevant implementation regulation, which has not yet been issued by the relevant authorities.

At a practical level, Italian law requires security interests to be registered in the name of each lender, which means that the security must be retaken or reregistered when a lender transfers its interest in a loan to another lender, whether as a result of syndication or otherwise. It should also be noted in this respect that there is no 'security trust' concept to facilitate syndicated structures and that the parallel debt structure is untested before Italian courts.

The ability to operate in Italy and to benefit from full security can be achieved by non-licensed entities through the adoption of 'fronting structures' whereby a licensed lender based in Italy makes available to an Italian borrower certain credit facilities under the terms of a credit agreement, while other lenders participate by way of back-to-back loans or back-to-back guarantees under the terms of separate agreements (similar to participation or sub-participation agreements).

In order to increase market transparency and accountability, lenders and intermediaries must also carry out certain 'know your customer' checks similar to the requirements in other jurisdictions.

ii Recent developments

Law Decree No. 18 of 14 February 2016 (Decree 18) provides new rules that will expressly allow EU alternative investment funds (AIFs) to 'invest' in loans (where 'invest' also includes origination) to non-retail consumers, subject to certain conditions.

In order to be eligible, the relevant AIF would have to: (1) be authorised to invest in loans in such AIF's jurisdiction of incorporation and (2) be formed as a closed-end fund with rules comparable with those of an Italian AIF, including with respect to risk mitigation and diversification limits (e.g., lending limits).

Prior to making the loan, the manager of the AIF should notify the Bank of Italy of its intention to 'operate' in Italy and, within 60 days of such notice, the Bank of Italy has the discretion to stop the proposed investment.

Please note that the Bank of Italy must issue rules and regulations for the implementation of Decree 18, including rules requiring AIFs to register with the Central Credit Register, which the AIFs would be permitted to do through licensed banks or financial intermediaries. Until the Bank of Italy issues such rules and regulations the new regime is unlikely to be workable in practice.

iii Tax

Withholding tax

A 26 per cent withholding tax rate (or the different rate provided for by applicable tax treaties) is applicable on interest paid by Italian residents to non-Italian residents. Payments to Italian residents are not subject to any withholding tax and no withholding tax applies on interest

2 Cassa Depositi e Prestiti is a joint-stock company under public control, with the Italian government holding 70 per cent and a broad group of bank foundations holding the remaining 30 per cent.

paid to and beneficially owned by Italian resident banks or Italian permanent establishments of foreign banks. The sub-participation of a loan is generally 'transparent' for Italian tax purposes and interest is subject to withholding tax as if it was paid directly to the participant.

Italian tax law provides, however, for certain additional exemptions from this withholding tax, and Decree 91 introduced important exemptions for EU banks, insurance companies incorporated and authorised pursuant to laws enacted by EU Member States and certain EU credit collective investment institutions, *inter alia*. By way of example, no withholding tax applies on interest paid on medium-term loans (i.e., loans having a duration longer than 18 months) advanced to Italian 'enterprises' by:

a banks established in the EU – including Italian banks or Italian permanent establishments of non-resident banks;

b insurance companies incorporated and authorised pursuant to laws enacted by EU Member States;

c foreign institutional investors (e.g., investment funds or investment companies) established in 'white list' countries (both EU Member States and non-EU countries) provided they are subject to regulatory supervision in the country in which they are established – regulatory supervision is deemed to exist where activities are subject to continuous controls pursuant to the laws of the state in which they are resident.

Other tax considerations[3]

Registration taxes, mortgage tax, stamp duty and substitute taxes should also be taken into consideration. In particular, please note that substitute tax – equal to 0.25 per cent of the aggregate principal amount of the incurred debt – could be applicable at the option of the borrower only to medium-long-term loans (i.e., loans having a duration longer than 18 months); if not applicable, likely other Italian registration or stamp taxes apply depending on the specifics of the security which can therefore be significantly more costly. Proper opinion by fiscal advisers should be obtained regarding these matters.

iv Achieving deductibility of interest expense against operating income

In general terms, pushdown of acquisition financing is implemented in two phases. Initially, short-term debt is made available to a newco controlled by the sponsor to acquire the target entity. To avoid any financial assistance issues, this debt is likely to be supported only by a share pledge over the newco and the target. After perfection of the acquisition, a direct (or reverse) merger between the newco and the target takes place, subject to a specific procedure that also contemplates a debt sustainability test at the level of the merged entity. In this second phase, the short-term debt is transformed into long-term debt that can be supported, in addition to the share pledge over the merged entity, by security interests over any significant asset of the borrower.

From a tax perspective, please note that in the past, the Italian tax authority has in certain instances challenged the deductibility of interest expenses incurred in connection with acquisition financing for leveraged buyout (LBO) transactions culminating in the merger of the bidco and the target. To date, in light of the clarifications provided by the Italian revenue agency's circular letter 6/E of 30 March 2016, interest expenses incurred in connection with

3 Please refer to Section II.iv, *infra*, for further comments relevant from a tax perspective.

the acquisition financing for LBO transactions should be considered, in principle, as having business purpose and therefore be deductible. Abusive transactions are still subject to tax authority review.

v Other major regulatory concerns

Usury laws are strict in Italy and require the applicable interest rate not to exceed a certain threshold. In order to avoid any issues, the parties usually agree contractually that if, pursuant to a change in law or in the official interpretation of Italian usury laws, the applicable rate of interest or default interest at any time is deemed to exceed the maximum rate permitted by Italian usury laws, then the relevant interest rate (or default interest rate) is automatically reduced to the maximum interest rate permitted pursuant to such legislation, for the period during which it is not possible to apply the interest rate as originally agreed between the parties.

Other issues that can arise for debt finance in Italy include issues under data protection and data retention laws, and transparency rules and other regulations that impose certain requirements, formalities and duties for the exercise of banking activities and provision of financial services in Italy. These are outside the scope of this chapter and are not addressed further.

III SECURITY AND GUARANTEES

i Forms of security and guarantees

The usual kinds of security and guarantees created under Italian law in the context of a leveraged financing are the following:

Mortgage

A mortgage is an *in rem* security interest created on registered property such as real estate registered in public land registers, and entitles the mortgagee to enforce his or her security interest with priority over other creditors. As a consequence, any proceeds obtained from enforcing the mortgage must be used to repay the mortgagee up to the amount that is due.

Security over real estate may only be taken in the form of a mortgage that is registered with the land register. In contrast to certain other jurisdictions, a mortgage does not create or involve upon perfection any transfer of ownership of the real estate.

Mortgages can also be granted over specific tangible moveable property that is registered with official registries, such as motor vehicles, ships and aircraft.

Specific formalities are required for mortgages, including the execution of a notarial deed of mortgage and its registration.[4]

4 Special formalities apply when granting mortgages over ships and aircraft. *Inter alia*, should a mortgage be taken over an aircraft or a ship pursuant to Italian law, the relevant security document must be in the form of a notarial document and the mortgage must be registered at the national aeronautical register or the navy register. Furthermore, should the security be taken with regard to an aircraft under construction, the mortgage must also be registered at the relevant construction register.

Real estate mortgages are enforced through a court-administered enforcement procedure which requires the secured creditor to demonstrate its right to the enforcement (e.g., notarial deed or enforceable court order) and submission by the secured creditor of a notice through a court bailiff demanding payment within a specified deadline and warning the debtor that, in the event of non-payment, an enforcement proceeding will be commenced. The enforcement may be made either by auction or direct sale with court approval.

Pledge

A pledge is an *in rem* security interest created over financial instruments (e.g., equity stock and debt instruments), cash deposits, receivables and intellectual property rights. The requirements for creation and perfection of a pledge differ depending on the assets being charged but generally involve the delivery of the pledged assets (or delivery of the document which confers rights over the assets) to the pledgee or to a third-party custodian appointed by the parties.

In the case of a pledge over quotas of an Italian limited liability company, the relevant security document must be entered into in notarial form owing to the requirement for registration of the security interest with the competent companies' register; this formality is however not required for a valid pledge over the shares in a joint-stock company. In the case of a pledge over financial collateral (securities and cash deposits), the pledge is formalised in a simplified way introduced by Decree No. 170/2004, implementing the Financial Collateral Directive.[5] Should a pledge be created over intellectual property, there is also a requirement for notarising the security document and registering the security with the Italian office for trademarks and patents. With regard to copyright, it is also considered advisable to take security over the receivables arising from its use.

A pledge creates a privileged claim, in most cases requiring the pledgee to take action to realise the security following the occurrence of an enforcement event. This can include a private sale, enforcing the security by means of a court procedure, serving notice on the debtor through a court bailiff demanding payment of the debt or, where applicable, an appropriation in accordance with Decree No. 170/2004. The object of the pledge can only be appropriated up to the amount due to the privileged creditor, while any surplus value must be returned to the debtor.

Assignment of receivables by way of security

Contractual receivables (e.g., claims for services released or goods sold, intercompany receivables, sponsorship receivables, dividends) can also be assigned by way of security to the secured creditor or assignee. This kind of security requires, for the perfection of the security interest, a notice to be served to the debtor by a court bailiff in order to establish the certainty of date, or alternatively the debtor may acknowledge the assignment with an instrument clearly stating the certainty of date.

Special lien

A special lien is a security interest that can be granted over various assets such as existing and future plant, equipment and machinery, licences and instruments, and also over existing raw materials and receivables arising from disposal of any of these assets. In contrast to other

5 Directive 2002/47/EC.

kinds of security interest, this can only be created to secure medium-long term facilities (i.e., facilities having a maturity term exceeding 18 months) granted by banks licensed to carry out business in Italy or in favour of the representative of the bond holders in the context of bonds that are of medium-to-long-term tenor, issued by joint-stock companies, subscribed by qualified investors and approved for trading only among such qualified investors.

Formalities for this kind of security include a written agreement in notarial form describing the assets and the main terms and conditions of the secured loan, together with transcription of the agreement with the relevant court register or registers as applicable.

Guarantee or suretyship

A guarantee provides a guarantee of payment obligations (including future obligations) up to a maximum specified amount. It is a consensual quasi-security arrangement frequently provided by parent companies in the interest of subsidiaries. It is generally obtained by a creditor in addition to other forms of *lato sensu* security or collateral used to secure indebtedness.

The guarantor might obtain the *beneficium excussionis*, pursuant to which it will be required to pay only subject to previous unsuccessful enforcement against the debtor. It should be noted that, according to the general principles of Italian law, guarantors and original debtors are jointly liable. Therefore, should a guarantor seek, from a commercial perspective, to obtain the aforementioned *beneficium excussionis*, specific provisions must be inserted in the relevant agreement.

First demand guarantee

A first demand guarantee is a guarantee of payment obligations up to a maximum specified amount, payable on first demand. Should the guarantor be required to pay, the guarantor is not entitled to raise any defences, including those that are based on the underlying relationship from which the credit originated. Therefore, should the guarantor receive a claim that is formally valid (i.e., presented according to the provisions included in the relevant agreement), there is no basis for rejection of payment.

ii Limitations on the grant of security and guarantees

Financial assistance

Italian companies are restricted from directly or indirectly providing financial assistance by any means for the acquisition of or subscription for its own shares or quotas or for the acquisition of or subscription for shares or quotas owned by its direct or indirect controlling parent. Financial assistance for the refinancing of indebtedness originally incurred for a third party's acquisition of or subscription for its own shares or quotas or those of any entity that (directly or indirectly) controls the Italian company may also be construed as a violation of applicable Italian law. Any loan, guarantee or security given or granted in breach of these provisions is null and void.

There is a limited exemption to these restrictions which requires that the board of directors may pass a resolution that approves a report:

a outlining the legal and financial terms of the transaction to be put in place;
b outlining the underlying business interests and corporate benefits pursued;
c outlining the risks characterising the transaction considered;
d providing an arm's-length analysis especially focusing on the perimeter of the security package to be granted, and the relevant terms and conditions of the financing; and

e providing an assessment of the creditworthiness of the party receiving financial assistance.

Finally, the amount of the financing or guarantees may not exceed the limit of distributable profits and available reserves of the company registered in its last approved financial statements.

Corporate benefit

The granting of a guarantee or security for obligations undertaken by companies belonging to the same group requires, particularly, that the relevant Italian company, as guarantor or chargor, obtains a direct or indirect tangible benefit from the transaction in the context of which the issuance of the guarantee or security is granted.

The Italian legal principles on corporate benefit apply equally to downstream, cross-stream and upstream guarantees and security granted by Italian companies. While the existence of corporate benefit for a downstream guarantee or security is often clear, the validity and effectiveness of an upstream or cross-stream guarantee or security depend on the existence of a real and adequate benefit in exchange for the granted guarantee or security and it is necessary to demonstrate that the issuance of the guarantee or security falls within the corporate purpose of the Italian company and is in its corporate interest. The existence of a corporate benefit for an Italian entity is ultimately a matter of fact – rather than a legal concept – to be carefully evaluated by the management of the relevant Italian guarantor or chargor, and the guaranteed or secured amount must not materially exceed the financial capability of the Italian guarantor or chargor. Finally, the maximum guaranteed amount under the guarantee or security must be indicated expressly.

iii Security agents

Security agents feature in many syndicated financings and securitisations in the Italian market. However, there is no 'security trust' concept under Italian law, and the 'parallel debt' structure is untested and likely to be subject to court scrutiny in a bankruptcy scenario.

iv Floating charge

The newly enacted Law No. 119 of 30 June 2016 (Law 119) has introduced the 'floating charge'. In particular, it provides that:

a the assets subject to security remain in the possession of the relevant company;
b the security can charge non-tangible assets;
c the security may charge receivables arising from, or otherwise pertaining to, the chargor's business;
d secured creditors are entitled to bring judicial action for urgent and interim protection, in the event of misuse of the charged assets;
e an enforcement notice to the chargor and borrower can be given directly by the secured creditors by certified email, as opposed to going through the court procedure provided by the Italian Code of Civil Procedure;
f the chargor and borrower can object within five days of an enforcement notice, as with common possessory pledges;
g the chargor's obligation to deliver the charged assets to the secured creditors within 15 days of receipt of the enforcement notice for appropriation purposes and pursuant to their estimated value;

h clarifies that the security will prevail over enforcement proceedings brought by unsecured creditors; and
i the deeds must be executed in notarial form and registered with the competent Italian authorities.

IV PRIORITY OF CLAIMS

i Liquidation of a company's assets

The order of distribution of a bankrupt company's assets by a receiver is governed by the principle of equality among creditors – except for priority creditors (the principle of proportionality and ranking) – and is as follows:

a super-senior credits owed to creditors holding mortgages on immoveable assets or pledges of moveable assets, with reference to those proceeds arising from the sale or liquidation of the relevant charged assets;
b deductible credits arising on occasion of, or in relation to, the insolvency procedure or that are considered super senior by special provisions of law. Credits arising during the procedures that are liquid and collectable, and whose preference and amount are undisputed, may be satisfied outside the distribution process if the assets are deemed sufficient to satisfy all the holders of those claims;
c privileged and secured credits, including credits of the Italian tax authority, social security administrator or credits owed to creditors holding mortgages on immoveable assets or pledges on moveable assets, only with reference to the portion of their claims not reimbursed or repaid by means of the sale or liquidation of the charged assets;
d unsecured credits: these creditors usually receive a *pro rata* share of the distributed funds (unless available resources are sufficient to repay every unsecured creditor), ranking after privileged and secured credits; and
e shareholders' credits (shareholders normally receive distributions only if funds are available after satisfaction of the foregoing); holders of preferred shares take priority over ordinary shareholders.

The date of execution or perfection of each security interest determines its relative priority in relation to other security interests; applicable law determines relative priority between privileged credits. It should be noted that, according to Italian law, any exception to the *par condicio* among creditors must be linked to a specific legislative provision, and no priority rights other than those expressly provided for under Italian legislation can be created.

ii Subordination

Structural subordination

Structural subordination is commonly used in Italian financings and is achieved through the structure of the financing transaction rather than by any express contractual agreements between lenders and borrower or guarantor. Generally, the senior lender makes a loan to the operating company that generates the flow of funds needed for repayment, while the borrower of the subordinated lender's loan instead is a holding company that owns limited or no assets other than the shares that it holds in the operating company.

Contractual subordination

Contractual subordination is an agreement in which junior creditors agree they will not receive repayment of their claims unless the senior creditors have been repaid. Contractual subordination should be enforceable in a bankruptcy scenario provided that the agreement documenting the subordination is not subject to a clawback action carried out by the relevant receiver on the basis that it was entered into within the relevant 'suspect periods' set out in the Italian bankruptcy law. Because there has not been case law enforcing intercreditor agreements to date, intercreditor agreements are often used together with structural subordination, and among other things deal with senior creditors' ability to enforce security by way of disposal of the business, related releases of the security, and related releases of subordinated creditors' debt and guarantee claims.

V JURISDICTION

A contractual jurisdiction clause in an Italian law agreement will usually provide for either 'exclusive' or 'non-exclusive' jurisdiction. The Italian Supreme Court has upheld the validity of this type of clause, although mandatory provisions of law – i.e., provisions regarding specific enforcement proceedings – apply independently from contractual jurisdiction clauses.

VI ACQUISITIONS OF PUBLIC COMPANIES

Any loan agreement financing the acquisition of a public company must have no unsatisfied conditions precedent to draw down simultaneously with the announcement of the offer; the only permissible exception entitles the debt provider to withdraw its finance (during the 'certain funds' period) relating to the solvency of the bidder for failure to satisfy the conditions under which the bid is made.

i Fund requirements

The need to ensure that any funds needed for the bidder to pay the shares tendered to the offer are available to it on a 'certain funds' basis is addressed by the National Commission for Companies and the Stock Exchange (Consob) Regulation. This mainly requires the cash consideration to be secured by a cash confirmation letter (CCL) in a form acceptable to Consob. Such CCL usually takes the form of a letter from the debt providers confirming that the relevant funds are available under the relevant tender offer facility.

ii Mandatory offers triggered by a share pledge or enforcement of a share pledge

According to Italian laws regulating public acquisitions, a mandatory takeover bid is required when a person has acquired more than a certain percentage of the voting securities (i.e., listed shares and financial instruments, carrying voting rights to be exercised in the context of shareholders' meetings to appoint or remove the directors or the supervisory board of a listed Italian company). In particular, mandatory offers are required in the following circumstances.

Offer for all the outstanding voting securities of a listed Italian company

Any person who (alone or with any concert party) acquires, through making purchases, 30 per cent or more of issued share capital or the issued securities that carry voting rights of a listed Italian company, must launch an offer for all the remaining voting securities. The relevant threshold for a tender offer has been lowered to 25 per cent of the share capital in companies other than small and medium-sized listing companies when there are no other shareholders owning more than 25 per cent of such share capital. Special care should be taken with respect to shares that enjoy increased voting rights and multiple voting rights, introduced by Decree 91. In particular, such shares have to be taken into account to verify whether the relevant thresholds are exceeded.

Incremental offer

The same rule also applies to any person who (alone or with any concert party) already owns more than 30 per cent of the voting shares, but does not own the majority of voting rights generally exercisable at a meeting of ordinary shareholders in such issuer. If that person acquires within a 12-month period (either through direct acquisition or by exercise of subscription or conversion rights acquired during the period) a further shareholding representing more than 5 per cent of the company's voting securities, such person must also launch a mandatory offer for all the remaining voting securities.

Sell-out

Minority shareholders in the target have the right to sell their voting securities to the majority shareholder in either of the following scenarios:

a where, following an offer for 100 per cent of the target's voting securities, the offeror comes to own 95 per cent or more of the voting securities in the target; or

b where any person comes to own more than 90 per cent of the target's voting securities listed on a regulated market, unless such person sells a sufficient proportion of the target's voting securities to ensure regular trading in the voting securities within 90 days.

iii Minority squeeze-outs

Under Italian law, an offeror has a statutory 'squeeze-out' right to acquire minority shareholdings where, following an offer for 100 per cent of the voting share capital of a target company, it comes to own a shareholding equal to at least 95 per cent of the voting securities of the target. This right can only be exercised if the intention to do so was set out in the offer document, and within three months of the date of closing of the offer. Where the target company has different classes of voting securities, the rights of the offeror can only be exercised for each class of securities in which the 95 per cent threshold has been reached.

iv Disclosure requirements for financing terms (including flex and fees)

The main disclosure requirements are as follows: an announcement of the offer containing a minimum set of information, including the method of financing the offer; guarantee of payment (included within the key documents relating to the offer); and the date and method for settlement of the consideration, together with details of any guarantees of due performance of the payment obligation.

v Confidentiality requirements and other restrictions

If a debt provider proposes to syndicate its loan to the bidder to persons who are also shareholders in the target company, Consob must be consulted to ensure that there is no breach of the rules concerning favourable conditions being offered to some but not all shareholders.

Chapter 14

JAPAN

Naoya Shiota and Yusuke Murakami[1]

I OVERVIEW

In typical leveraged buyouts in Japan, mainly by private equity funds, the acquisition is financed with an equity investment from a sponsor (e.g., a private equity fund) and debt financing as described in detail below.

The debt financing package typically consists of a senior term loan and a revolving facility for working capital purposes (if needed), both of which are usually provided by banks. The senior term loan may be initially provided as bridge financing at the time of acquisition (the loan period of which is usually around six months to one year after the first use) and later refinanced by a permanent loan. There is no standardised form of leveraged loan agreement, but the model syndicated loan agreement published by the Japan Syndication and Loan-trading Association may be used as the basis of the documentation. Also, the Japanese version of the document that has similar contents to the form of the facilities agreement for leveraged acquisition finance transactions produced by the Loan Market Association is sometimes used.

Some transactions also make use of the mezzanine financing, which is usually structured with subordinated loans, subordinated bonds, subordinated convertible bonds or preferred shares. Such mezzanine financing sometimes entails similar covenants to the senior loan, but the exercise of rights by the mezzanine financing providers is restricted under an intercreditor agreement (see Section IV.I, *infra*, regarding the structure of the subordination among creditors). The preferred shares are sometimes structured to be non-voting, while in other cases they may be convertible into voting shares. The timing of when the preferred shares (or subordinated convertible bonds) can be converted into voting shares varies in each case, and this issue is usually subject to extensive negotiation between the equity sponsor and the holders of preferred shares (or subordinated convertible bonds).

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Interest payments (or dividend payments for the preferred shares) for mezzanine financing often include cash interest, which is paid periodically before maturity, and payment-in-kind interest, which is usually structured as compounded interest or periodical capitalization of interests, in each case such interest or principal becomes payable on the maturity date (after full repayment of senior debt). Equity kickers, typically in the form of stock options for no subscription price, are sometimes granted to mezzanine finance providers as a sweetener. Under the typical structure, the equity kickers become exercisable and can be converted into common shares either upon the exit of the equity sponsor or a public offering by the target company, and the exercise price per common share is set to be the same price as per share paid by the equity sponsor for its shares.

In relation to the timeline for arranging the financing, the acquirer often obtains a commitment letter from lenders at the time of signing a stock purchase agreement or other acquisition agreement, and then enters into a definitive loan agreement before the closing. Typically, one or more arranger banks submit a commitment letter to underwrite the facilities, and in exchange obtain the mandate from the borrower. The commitment letter usually attaches a term sheet that sets out basic terms of the facilities. The level of detail in the term sheet varies by transaction, but the term sheets in acquisitions of public companies are usually quite lengthy and detailed (see Section VI.I, *infra*).

The syndication may be made between the issuance of the commitment letter and the initial drawdown, or after the initial drawdown. The general syndication period is usually a period of six months to one year after the signing of the definitive loan agreement or first use of the facility.

One recent topic in the Japanese financial markets has been how to structure interest payment terms in the midst of the current negative interest rate environment. Since the introduction of the negative interest rate policy by the Bank of Japan in January 2016, there have been ongoing arguments over how to deal with negative interest rates in loan transactions or hedging products corresponding to loans. Although there have been a growing number of loan agreements with 'zero floor' provisions applied to the base rate (such as LIBOR or TIBOR), a general practice has not yet been established.

II REGULATORY AND TAX MATTERS

i Licensing

A domestic or foreign entity that intends to engage in the lending business in Japan must be registered with the relevant authorities and conduct its business in accordance with certain regulatory requirements under the Money Lending Business Act (MLBA), subject to certain exceptions such as a domestic bank and a foreign bank branch.

An issue that has often arisen is the potential risk of application of the MLBA to intra-group lending made by an acquisition entity to the target company group after the acquisition. In practice, the acquirer sometimes directly or indirectly lends money not only to the target company but also to its affiliated companies (including those not wholly owned by the holdco). Until recent amendments to the MLBA in April 2014, the scope of application of the MLBA to intra-group lending had not been entirely clear. The Financial Services Agency of Japan (FSA) had stated in prior no-action letters that an intercompany loan provided by a parent company (as the lender) holding the majority stake in its subsidiary (as the borrower) is exempt from the regulation, but that such exemption does not apply to intra-group lending between sister companies held by the same parent company.

The latest amendments to the MLBA and related regulations have expressly set forth a set of safe-harbour rules that are fairly wide and flexible compared with those indicated by previous no-action letters. Under the amended regulations, the regulatory requirements do not apply to the following lending activities:

a lending conducted between certain affiliated companies belonging to the same group that consists of a parent company and its subsidiaries whose financial and business decisions are considered to be effectively controlled by the parent company in light of certain criteria[2] (including lending between sister companies); and

b lending to a joint venture by a joint venture partner holding 20 per cent or more of the voting rights of the joint venture with consent from all the other joint-venture partners.

These amendments are likely to facilitate flexibility in the use of intra-group lending in the context of leveraged finance transactions.

ii Interest limitation

Japan has usury laws limiting the amount of interest that can be charged for loans. The maximum interest rate for a loan with a principal amount of more than ¥1 million is effectively capped at 15 per cent per annum under the Interest Rate Limitation Act (IRLA) and other related regulations.[3]

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2 Under the relevant ordinance, financial and business decisions of a subsidiary are considered to be controlled by a parent company in any of the following events:

a the majority of the voting rights of the subsidiary are held by the parent company on its own account; or

b 40 per cent or more of the voting rights of the subsidiary are held by the parent company on its own account and any of the following conditions are satisfied:

- the voting rights held by the parent company combined with those held by any related parties who are presumed (due to certain circumstances) to or have agreed to exercise the voting rights in concert with the parent company account for more than 50 per cent of the voting rights of the subsidiary;
- the parent company's (incumbent or former) officers, executive members or employees constitute the majority of the board or any equivalent organisation of the subsidiary;
- there is an agreement pursuant to which the parent company controls material financial and business decisions of the subsidiary;
- the amount of financing provided by the parent company (and certain related parties) accounts for more than 50 per cent of the total amount of the subsidiary's financing; or
- there are any other circumstances indicating that the parent company controls the financial and business decisions of the subsidiary.

3 The Act on Receipt of Contributions, Deposits and Interest Rates and the Temporary Interest Rate Adjustment Act also contain certain restrictions on interest rates. In addition, the MLBA prohibits any licensed lender from entering into a loan agreement that breaches the interest limit provided by the IRLA.

One potential pitfall is the concept of 'deemed interest' adopted by the IRLA and other related regulations, where 'moneys other than principal received by a lender in connection with a loan shall be deemed to constitute interest even if such moneys are called gratuity, discount, commission, research fees or any other names'. The scope of this concept looks so broad on the surface that it is not quite clear whether various fees will be deemed to constitute interest. Commitment fees are expressly exempt from the 'deemed interest' regulation if certain requirements are met under the Act on Specified Commitment Line Contract. It is also the common understanding that agent fees and arrangement fees will not be deemed to constitute interest as long as services provided by an agent or an arranger are not a sham. The treatment of prepayment fees is arguable, but upfront fees are likely to be deemed to constitute interest.

Although there is a good argument that the original spirit of this regulation was a safeguard against 'predatory lending' and should not apply to wholesale syndicated loan transactions, the government has not published any official guideline to exempt wholesale loans from the 'deemed interest' regulations. Therefore, it is quite important to carefully structure a well-balanced package of various fees and interest charges in order to minimise the risk of breaching the statutory interest limitation, especially in the case of mezzanine or second-lien financings with relatively high interest rates.

III SECURITY AND GUARANTEES

i Regulations applicable to upstream guarantees and security

There are no specific rules on financial assistance, such as upstream guarantees or provision of security, in Japan. However, the general fiduciary duty owed by the directors of the target company to its shareholders should be applied when the target company provides a guarantee or security to secure the acquisition financing. It is generally understood that directors of the target company could be found to breach their fiduciary duties if the target company provides guarantees, security or other financial assistance solely for the benefit of a majority shareholder. Therefore, it is common for the target company to refrain from providing this financial assistance before either the acquirer purchases 100 per cent of the shares in the target company or the borrower obtains consents from all of the minority shareholders in the target (in the case of a partial leveraged buyout).

ii Security packages

Lenders usually take security over the shares in the target company to be purchased by the acquiring entity (as well as the shares in the acquiring entity, in most cases). The acquiring entity usually provides security over its assets, such as bank accounts and intercompany loans.

In addition, from the time when upstream financial assistance can be granted without breaching fiduciary duties, the target company and its wholly owned subsidiaries also provide guarantees and security over their assets. It is not uncommon that the lenders require all of the wholly owned subsidiaries (except for companies in foreign jurisdictions) to become a guarantor, but the scope of the guaranteeing subsidiaries may be limited only to material subsidiaries selected by revenue, profits or other criteria.

Lenders often request security over substantially all assets owned by the target company and the guarantors, but the security package is eventually determined based on a cost-benefit analysis, legal feasibility and other factors.

A 'blanket lien' (i.e., a lien that gives a creditor the entitlement to take possession of any or all of the debtor's property to cover a loan) that is available in some jurisdictions is not available for bank loans in Japan. Therefore, it is necessary to individually attach security interests over each type of asset. Only with respect to moveable assets and claims (e.g., trade receivables) is it legally possible to create security over current and future (after-acquired) assets that may change from time to time to the extent that the scope of the security can be identified by location, types of assets or underlying agreements. In addition, the registration of security over certain assets, such as real estate, requires payment of a registration tax. Therefore, in some cases lenders choose not to initially register the security, but the borrower and the lenders agree to register the security upon the occurrence of certain events such as event of default. In addition, in relation to a mortgage over real estate, a provisional registration, which may maintain the ranking with less cost but entail limited power upon the enforcement, is also available. Granting a security interest over some assets (e.g., trade receivables and deposits under lease agreements) may also require consent from a third party, and in that case those assets are sometimes excluded from the security package.

iii Security trusts and parallel debt

One typical issue in the structuring of secured syndicated loans in Japan is how to create security for a group of lenders. This point is important especially for non-Japanese lenders who would practically need to appoint an agent to manage and enforce on their behalf their security interests over assets located in Japan. Traditionally, it has been a generally accepted principle in Japan that security must be held by the creditors to whom secured obligations are owed by an obligor. Therefore, each lender is named as a secured party in most syndicated loan transactions in Japan, which can be quite burdensome when there is a transfer of loans or a collective enforcement of security interests.

In 2007, the Trust Act of Japan was amended and the concept of a security trust was introduced, but as a matter of practice, security trusts have not been frequently used to date due to a number of drawbacks that must be overcome. One hurdle is a substantial increase in transaction costs, which results from fees payable to a trust bank or a trust company acting as the trustee of a security trust[4] and also from additional mortgage registration fees required for perfection of mortgages held by a security trust.

A conceivable alternative option is the use of a parallel-debt structure, where a security agent holds security to secure parallel debts owed to it by the borrower, rather than to secure each lender's corresponding loan disbursed to the borrower. Although the concept of parallel debt is novel to the Japanese legal community and there have been no reported domestic transactions using a parallel-debt structure governed by Japanese law, it should be theoretically feasible to create a parallel-debt structure under Japanese law. Whereas the Civil Code of Japan recognises the concept of joint and several obligations among multiple obligors, it does not expressly provide for the concept of joint and several claims among multiple creditors. That said, it has been generally understood that joint and several claims among multiple creditors can be validly created by contract.

One potential drawback to the parallel-debt structure may be the need to carefully examine the credit risk of the security agent, which could materialise if a creditor of the

4 In order to provide trustee services (including those as a security trustee) in Japan, a trustee must be licensed pursuant to the Trust Business Act.

security agent were to attempt to seize and collect all or part of the parallel debt, or where an insolvency trustee might seek to collect parallel debt in connection with a security agent's insolvency proceedings. That said, the use of parallel debt structures has been gradually expanding and it will likely be established as a common option for collective security arrangements in the near future.

IV PRIORITY OF CLAIMS

i Senior loans versus subordinated loans

Subordination clauses

In Japanese syndicated loan practice, there are two acknowledged methods of subordination. First, multiple lenders and the borrower can freely agree in the form of an intercreditor agreement that some lenders shall be subordinated in a certain way with respect to repayment and distributions by the borrower (relative subordination). It should be noted, however, that Japanese insolvency laws allow the insolvency trustee of the borrower to disregard all or part of such an intercreditor agreement in order to achieve an equitable distribution for all the relevant creditors.

To overcome such risk, the transaction parties can expressly provide in subordinated loan documents that the borrower's obligation to repay the subordinated loans shall be suspended upon the commencement of any insolvency proceedings or acceleration (default) of a loan, and not come into effect again until all the senior claims have been fully repaid (absolute subordination). This type of subordination clause built into a loan document itself will be respected by the insolvency trustee.[5] That said, it should be noted that a relative subordination arrangement could sometimes lead to a greater distribution to senior lenders as a result of subsequent turnover (sharing) from junior lenders to senior lenders (setting aside the credit risk of junior lenders). For these reasons, senior lenders as well as mezzanine lenders sometimes prefer relative subordination rather than absolute subordination.

Equitable subordination

Under Japanese insolvency laws, there is no established principle of 'equitable subordination' by which claims of a major shareholder or certain interested individuals in control of the debtor's business should be treated as subordinated to other general creditors for the purpose of equitable liquidation or reorganisation. If the insolvency proceedings take the form of a civil rehabilitation or corporate reorganisation, the court is expressly allowed to treat creditors of the same class differently in the final rehabilitation or restructuring plan to the extent that

5 In addition, Japanese insolvency laws have made it clear that certain claims (Article 99 II subordinated claims) that lenders and the borrower have agreed, prior to the commencement of insolvency proceedings, to treat as junior to any other claims whatsoever shall be treated as subordinated claims as agreed by the insolvency court. Under the above-mentioned absolute subordination structure, it is typical that the mezzanine lenders are junior to any claims with regard to the senior loan, which include interest or default interest arising after the commencement of insolvency proceedings, and as a result such mezzanine lenders also become junior to all other general claims in addition to the senior loan. Therefore, it is likely that mezzanine loans under an absolute subordination structure will be recognised as Article 99 II subordinated claims as well.

the principle of equitable resolution is not prejudiced, but in practice courts do not seem to exercise that power actively or frequently. There is a limited number of precedents in the field of corporate reorganisation where the court actually approved a reorganisation plan that treated the debtor's holding company or the debtor's representative director as being junior on the ground that the insolvency itself was caused by their mismanagement of the debtor's business.

ii Priority of claims in insolvency proceedings

Secured claims

Secured claims are given certain priority over unsecured claims depending on the type of insolvency. In the case of bankruptcy and civil rehabilitation, secured creditors can proceed to enforce their security interests outside the insolvency proceedings without any approval of the court. On the other hand, in the case of corporate reorganisation, secured creditors cannot enforce their security interests outside the court proceedings, where secured creditors shall be given priority over unsecured creditors based on the valuation of the relevant collateral but only be entitled to distribution after the restructuring of the debt (including potential haircut and amendment to the repayment schedule) approved by the court.

In terms of priority among secured creditors, Japanese law allows transaction parties to create and perfect most types of security interests in different priorities for the benefit of multiple creditors pursuant to certain procedures provided in the Civil Code and other relevant regulations. Accordingly, transaction parties need not rely on any special contractual or structural framework for second liens (lien subordination without payment subordination) under Japanese law. That said, the second-ranking secured creditors will typically be requested by the senior lenders to enter into an intercreditor agreement in which they covenant not to enforce their security interests without approval of the first-ranking secured creditors.

Unsecured claims

Non-secured bank loans are usually treated as general claims in Japanese insolvency proceedings, and are subordinated by law to the following two senior claims: common benefit claims (such as costs and expenses arising from insolvency proceedings and certain other types of claims having common benefits for the overall creditors); and preferred general claims (such as wages for employees and certain tax claims). It should be noted that claims arising from debtor-in-possession financing after the commencement of insolvency proceedings are treated as common benefit claims.

On the other hand, general claims are satisfied in priority to certain subordinated derivative or incidental claims (such as accrued interest, damages or penalties for contractual breach and delinquent taxes arising after the commencement of insolvency proceedings) pursuant to the relevant insolvency laws.

V JURISDICTION

Japanese courts generally recognise the validity and effectiveness of a choice of law and jurisdiction provided in a loan agreement and any other related finance documents. Whereas a purely domestic syndicated loan is normally governed by Japanese law, a cross-border leveraged financing with non-Japanese lenders is often governed by English law or New York law. Even where a facility agreement is governed by English law or New York law, security agreements with respect to collateral located in Japan are typically governed by Japanese law. Although, as mentioned before, the parallel debt structure is not yet commonly used in Japanese domestic syndicated loans, the structure has been already adopted for the Japanese portion of the security package in cross-border transactions since the Japanese conflict of laws rules allow transaction parties to create security interests governed by Japanese law to secure any obligation governed by non-Japanese law, namely parallel debts duly owed by the borrower to the security agent under English law or New York law.

Furthermore, Japanese courts generally recognise as valid and effective any final and conclusive civil judgment for monetary claims rendered by a foreign court, provided, *inter alia*, that:

a the relevant judgment rendered by the foreign court is final and conclusive;

b the foreign court is considered to have valid jurisdiction over the case in light of relevant Japanese laws and treaties;

c the unsuccessful party duly received service of process necessary for the commencement of the court proceedings or was otherwise afforded the opportunity to protect its own rights in accordance with certain procedures;

d the contents and proceedings of the judgment rendered by the foreign court are not considered to be contrary or prejudicial to the public order and good morals acknowledged in Japan; and

e there exists reciprocal recognition of foreign judgments between the relevant foreign jurisdiction and Japan.

However, in order for the winning party to enforce its rights awarded by the foreign judgment, the party must file a separate lawsuit and obtain from the competent Japanese court a judgment that approves the enforcement of the foreign judgment in Japan.

VI ACQUISITIONS OF PUBLIC COMPANIES

i Buyout financing

For acquisitions of public companies that entail leveraged buyout financing, the typical structure in Japan is a two-step acquisition, where the acquirer implements a tender offer to acquire a majority (practically, two-thirds or more) of outstanding shares in the target company, and then the acquirer completes a minority squeeze-out via a special cash-out procedure newly introduced in the Companies Act in Japan or by other means. The financings are typically made in several stages, for instance at the time of settlement of the tender offer, a cash distribution to minority shareholders upon the minority squeeze-out and a refinancing of the target company (if applicable).

Tender offer regulations with respect to financing

First, under the Financial Instruments and Exchange Law (FIEL), an acquirer is permitted to withdraw or cancel a tender offer after it is commenced only in very limited circumstances, and is not entitled to any ‘financing out’. In other words, the acquirer is prohibited from withdrawing an offer on the grounds that the acquirer could not obtain financing. Thus, the acquirer must have comfort that it can obtain the financing at the time of initiating the tender offer. In that regard, even though it is common for the acquirer to obtain only a financing commitment letter at the time of commencement of the tender offer, it is also common that the acquirer and the lenders will have negotiated the terms of the loan in detail and agreed on a detailed term sheet when the tender offer is commenced.[6]

Second, there are no 'certain funds' requirements under the FIEL, but there are certain regulations regarding the certainty of funding from the perspective of disclosure.[7] Specifically, the acquirer needs to disclose the source of funds in the tender offer statement, and is also required to attach to the tender offer statement a document that shows the existence of sufficient funds for the tender offer.[8] With regard to a tender offer funded by acquisition financing, a 'certificate of lending' issued by banks is usually used for this purpose. Pursuant to the guidance of the FSA, such 'certificate of lending' is the document that supports the certainty of the funding to settle the tender offer.[9] In addition, the FSA requires summary disclosure or attachment of a document describing the material conditions (if any) to utilisation of the financing. Accordingly, under current practice in Japan, it is common to list in the certificate of lending the conditions to utilisation, as well as to provide a summary of representations and warranties and events of default.

Security packages in public transactions

As discussed in Section III.ii, *supra*, the acquirer typically creates security over the shares in the target company that it acquires through the tender offer. Even though the target company is still a public company at the time of establishment of such security, it is commonly understood that the creation of security itself does not trigger a mandatory tender offer. However, if the lenders seek to dispose of such shares to a third party upon the enforcement of such security before the target company goes private, a mandatory tender offer may be required.

In addition, the target company and its wholly owned subsidiaries will provide a guarantee and security over their assets, but such provision of a guarantee or security will be after the completion of the minority squeeze-out, given the concerns regarding the fiduciary duty of directors of the target company as discussed in Section III.i, *supra*. Practically speaking, it would take approximately one month from settlement of the tender offer to completion of the minority squeeze-out if the special cash-out procedure under the Companies Act can be used (the acquirer must have at least 90 per cent of the voting rights in the target company in order to use such procedure), while it would take two to three months if conducting the minority squeeze-out via means other than the special cash-out procedure, as a shareholders' meeting of the target company is necessary. During this period, therefore, the lenders do not have direct recourse to the target company's assets.

6 It is typical that the definitive loan agreement is executed after the closure of the tender offer period and before the settlement of the offer.

7 Under the FIEL, there is no obligation to disclose the financing terms, including flex and fees.

8 The tender offer statement and its attachment are to be filed with the relevant government bureau and to be publicly disclosed through an electric disclosure system called EDINET.

9 'Q&A with respect to tender offer for shares' issued by the FSA by 3 July 2009 and updated or supplemented from time to time until 3 August 2012.

ii Share financing

Recently, there have been some transactions in which acquirers have obtained significant shares in the target companies without taking them private. If an acquirer obtains leveraged financing, the target company cannot provide a guarantee or security interest due to the fiduciary duty concerns as discussed above, and the only meaningful collateral to secure the loan would be a pledge over the acquired shares. In this case, if the acquired shares are listed and therefore subject to market volatility, a special mechanism may be put in place to cover any fall in the market price, such as a mandatory prepayment being triggered when the loan-to-value ratio exceeds a pre-set threshold.

VII OUTLOOK

Looking ahead, we anticipate that Japanese practice will be affected by practices in other jurisdictions. For example, there is no 'certain funds' requirement under Japanese tender offer regulations, and we still see a lengthy list of conditions to utilisation, even for the financing of a tender offer. However, in outbound transactions, where Japanese companies obtain loans from Japanese banks to fund the acquisition of foreign companies, the conditions tend to be more limited based on the concept of 'certain funds' or the 'sun guard provision'. These practices are likely to be introduced to, or at least have some influence on, domestic leveraged finance transactions.

Chapter 15

LUXEMBOURG

Laurence Jacques and Thomas Bedos[1]

I OVERVIEW

The major part of acquisition financing in Luxembourg mainly consists of bank loans (straight loans, syndicated loans, etc.), mezzanine loans (by junior lenders) and debt and equity-tainted debt instruments granted by shareholders or PE investors (including hybrid debt instruments such as preferred equity certificates, convertible preferred equity certificates, convertible and redeemable bonds). Almost all financing transactions include senior debt (for the largest amount) and junior debt (provided by shareholders, sponsors or other banks). Luxembourg is a particularly attractive location to set up the acquisition platform of a local acquisition special purpose vehicle (SPV), as its regulatory environment offers a wide panel of financing and debt instruments to investors, endowed with hybrid features likely to optimise the tax efficiency of acquisition transactions. A sizeable number of international and EU acquisitions are channelled through Luxembourg to benefit from those hybrid features.

Financial collateral arrangements governed by the Law of 5 August 2005 (the Financial Collateral Law), otherwise known as 'bankruptcy remote security packages', have proven to be a formidable weapon in facilitating the immediate take over of assets and out-of-court restructurings under the control of creditors. Similarly, the Luxembourg courts have demonstrated their willingness to adopt a consistent and pragmatic approach in their interpretation of the Financial Collateral Law, thereby enhancing the attractiveness of the jurisdiction for lenders.

II REGULATORY AND TAX MATTERS

i Licensing requirements

Most Luxembourg leveraged financing activity is carried out by foreign or European banks benefiting from the EU freedom of services, investment funds, pension funds, securitisation

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companies or PE investors. As a result of its relatively small territory, the loan activity of local banks and financial institutions is relatively limited. In addition, most bank activities are geared towards commercial rather than investment credit, and private banking remains the core of their business activities.

Banking and financial activities performed in Luxembourg are regulated by the Law of 5 April 1993 relating to the financial sector (the Law on the Financial Sector). The core activities of credit institutions – deposit taking and lending to the public – are regulated in Luxembourg and subject to the general prudential supervision of the Luxembourg financial regulator, the CSSF. Professionals engaged in the sole business of granting loans to the public for their own account must also obtain an authorisation as a professional of the financial sector from the CSSF.[2]

There is no material restriction on cross-border lending. EU credit institutions may grant credit through a branch or in accordance with the rules relating to freedom to provide services as long as this activity is regulated and supervised in their home country.

Loan origination activities performed by undertakings for collective investments, alternative investment funds, securitisation vehicles, specialised investment funds, pension funds or investment companies in risk capital do not require authorisation as professional lenders.[3]

Similarly, lending activities performed on single or ancillary basis, intragroup lending and loans granted to a limited number of persons do not require such authorisation.[4]

In a broader sense, any type of funding can be freely granted to Luxembourg entities as long as it does not qualify as financial sector activity, meaning the activity is not carried out in a professional and usual way in Luxembourg or the lender is subject in its home country to prudential supervision equivalent to that exercised by the CSSF.

ii Sanctions, anti-corruption and money laundering

Entities subject to prudential supervision that fail to comply with the laws, regulations, statutory provisions or regulatory instructions may trigger the application of administrative and criminal penalties. Administrative sanctions range from a simple warning to a temporary or definitive ban on the entity or its directors performing one or several types of financial activity in Luxembourg.

The unauthorised exercise of any activity reserved to credit institutions may trigger administrative penalties and criminal sanctions, including imprisonment of up to five years and fines of up to €125,000.

In terms of anti-money laundering regulations, following recommendations from the OECD's Financial Action Task Force, Luxembourg carried out a fundamental reform of its legislation and adopted the Law of 27 October 2010. This legislation broadened the definition of money laundering, expanding the list of primary infringements and the types of professionals concerned and reinforcing professional obligations. In Luxembourg, anti-money laundering rules are not limited solely to banks, but also apply to any participants in the financial sector, including service providers (auditors, chartered accountants, lawyers, etc.).

2 Article 28-4 of the Law on the Financial Sector.
3 Q&A of the CSSF on the status of PSF – Part II – pages 29, ff. version of 30 November 2015.
4 Ibid.

The anti-money laundering legislation requires financial actors to verify the identities of their clients or the beneficial owners of any assets before a business relationship can be established or a transaction concluded. Throughout the client relationship, professionals are required to examine transactions – more particularly regarding the sources of funds – and must report any indications of money laundering to the public prosecutor's financial information unit. It should be noted that banking secrecy laws do not apply during money-laundering prosecutions.

iii Other major regulatory concerns for debt finance

Banking sector

The Luxembourg credit industry is facing the new wave of regulatory and reporting obligations resulting from the financial crises, mainly through EU regulations. These impose new organisational and technical constraints on financial institutions, which are now subject to a whole set of new regulatory requirements, in particular following the implementation of the Capital Requirement Directive IV package and its subsequent regulations.

The Bank Recovery and Resolution Directive of 15 May 2014 (2014/59/EU) has been transposed into Luxembourg law[5] and recasts the guarantee deposit system applicable in Luxembourg. It also reshapes the Luxembourg legal framework applicable to the resolution and liquidation of credit institutions.

Automatic exchange of information

New reporting obligations have been recently implemented in Luxembourg. The Law of 18 December 2015 on the automatic exchange of financial account information (the AEoI Law)[6] entered in force on 1 January 2016. Financial institutions (FIs) in participating jurisdictions[7] will be able to collect relevant tax information about their clients (including account holders, beneficial owners and potentially controlling persons ('investors')) residing in other participating jurisdiction by enhancing their due diligence procedures. FIs will have to report such information to the local tax authorities. Subsequently, the local tax authorities of the FI will exchange the information with their counterparts in participating jurisdiction in which the investors are taxed.

The FATCA Law dated 24 July 2015 implemented the intergovernmental agreement entered into on 28 March 2014 between the Grand Duchy and the United States to comply with the FATCA regulation in force in the United States of America. This requires that any foreign financial institutions report to the US tax administration any US account holders (and US beneficial owners of passive non-financial foreign entities). FATCA imposes a 30 per cent US withholding tax on US-sourced payments to foreign financial institutions (including banks, brokers, custodians and investment funds) that fail to comply with the FATCA rules.

5 Law of 18 December 2015 on the resolution, reorganisation and winding-up measures of credit institutions and certain investment firms and on deposit guarantee and investor compensation schemes (the BRR Law).

6 Implementing the OECD standard on the automatic exchange of information.

7 As defined in the OECD Common Reporting Standard (CRS).

iv Tax matters

As a matter of principle, the potential tax issues to tackle in acquisition leveraged finance are mainly related to the interest deduction at the level of the borrower, as well as the withholding tax exposure on the service of the debt.

Under the amended Income Tax Act of 4 December 1967 (the Tax Act), interest paid by a Luxembourg-resident debtor to an arm's-length non-resident creditor will not generally be subject to Luxembourg withholding tax, except in very limited cases (i.e., profit-sharing bonds or notes). If the interest payment is made for the intermediate benefit of an individual beneficial owner who is resident of Luxembourg, it may be subject to a withholding tax of 10 per cent according to the Luxembourg law dated 23 December 2005.[8]

Based on the upcoming tax measures announced by the Luxembourg government on 29 February 2016, it is foreseen that from tax year 2017, the aforementioned 10 per cent withholding tax will increase to 20 per cent; however, the implementation of this increase will strictly depend upon the outcome of the parliamentary discussion and final approval.

There are no specific thin capitalisation rules in Luxembourg in respect of bank or unrelated financing and if, for example, an investor wants to leverage an acquisition as far as possible with bank debt, Luxembourg tax law would generally be very flexible and not impose any strict debt-to-equity ratios on ordinary taxable companies.

Informal limits are, however, applied by the tax authorities for the financing of acquisitions of shareholdings by intragroup loans. The Luxembourg tax authorities generally consider a ratio of 85:15 as being in line with the arm's-length principle, which means that up to 85 per cent of the purchase price of the participations can be financed by interest-bearing intragroup loans. Interest rates must be in line with the arm's-length principles evidenced by the transfer pricing report.

For the purposes of determining the debt-to-equity ratio, an interest-free loan from shareholders may be treated as equity for corporate income tax purposes, so it may be possible to structure funding with a 99:1 debt (interest-free or bearing)-to-equity ratio. A debt-to-equity ratio of 99:1 could also be achieved by using certain exit instruments such as tracking loans.

Funding structures should be analysed on a case-by-case basis. Any excess interest payments that result from an excess over the aforementioned debt-to-equity ratio would be reclassified as hidden profit distributions, subject to withholding tax at the 15 per cent rate generally applicable to dividends payments, unless the recipient qualifies for the affiliation privilege in Luxembourg.

At the borrower level, the interest payments or accruals on a financing instrument considered as debt for tax purposes can be deducted from its taxable basis. This is subject, however, to applicable limitations such as the 85:15 debt-to-equity ratio.

This may be further affected by the Anti-Tax Avoidance Directive formally adopted by the European Council on 12 July 2016, to be transposed into national law by 31 December 2018.

The upcoming exit of the United Kingdom from the EU should not have *a priori* any adverse effect when structuring the acquisition finance between Luxembourg and the

8 Also referred as the RELIBI Law '*Retenue à la source liberatoire*' related to payments of interest or similar income made since 1 January 2006 (but accrued since 1 July 2005).

UK as the applicable zero rate withholding tax by the EU Directive would be substituted by the provisions of the double tax treaty between Luxembourg and the UK, which currently provides for a full exemption on interest payments.

III SECURITY AND GUARANTEES

i Security packages

Luxembourg is known as one of the best places in the world in which to enforce security interest.[9] Security packages in acquisition finance transactions generally include financial collateral arrangements on claims, bank accounts and financial instruments, guarantees and mortgages on immoveable assets.

A Luxembourg debtor is allowed to grant security on all its (present and future[10]) assets. There are only limited restrictions on the granting of security to third parties provided for by law; the most salient example relates to Luxembourg securitisation companies who can only grant security on their assets to secure obligations they assumed for securitisation purposes or in favour of their investors (or their fiduciary representative) or in favour of the issuing vehicle participating in the securitisation.[11]

Luxembourg law does not provide for the creation of floating charges or debentures equivalent to those known in Anglo-Saxon jurisdictions. Luxembourg companies are, however, allowed to grant floating charges or debentures on their assets located abroad.

Pledges on business assets such as stock, customers, IP or equipment have a fewer attractions: they can only be granted in favour of certain institutions,[12] the pledgees are further subject to governmental approval, only 50 per cent of the business assets can be secured, they have a limited 10 year-duration and they are subject to registration formalities and duties.

Security on financial instruments and claims

Security arrangements on financial instruments and claims are governed by the Financial Collateral Law.[13] Financial collateral arrangements can take the form of a pledge, a transfer of title for security purposes, a repurchase agreement or fiduciary agreement and can cover any type of financial instruments (shares, bonds, units, options, loan notes, securities, etc.[14]) and claims (e.g., arising from a loan or a sale and purchase agreement, or monetary claims on a bank account) regardless of their governing law.

Financial collateral agreements must be capable of being evidenced in writing, on paper or in electronic format or any other durable medium, allowing the identification of the secured assets. There is no particular formalisation procedure required to create a security on financial instruments or claims.

9 World Bank Report Doing Business 2016.

10 With the exception of mortgages.

11 Article 61(3) of the Law of 22 March 2004 on Securitisation. Any security granted beyond these restrictions is void by operation of law.

12 Credit institutions and breweries.

13 The Financial Collateral Law implements the directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.

14 Article 1 of the Financial Collateral Law gives a very broad definition of financial instruments.

Depending on the type of secured assets, the performance of dispossession formalities is required to ensure the perfection of a financial collateral agreement.

Parties to a financial collateral agreement can freely determine the exercise of their rights during the secured period, theirs right to use the secured assets, and the enforcement event.

Financial collateral agreements can validly be granted to a security agent, a trustee or a person acting for account of one or several beneficiaries as long as such beneficiaries are determined or determinable. They can secure any present and future liabilities of a debtor without need for further identification.

Creditors benefiting from a financial collateral arrangement have rights *in rem* on the secured assets, giving them full and direct access to the secured assets on the enforcement event, and without need for prior notice.

Enforcement methods may vary depending on the type of assets secured and the agreement of the parties. There is no requirement to initiate any proceeding in court before enforcing a financial collateral agreement. The Luxembourg judge's role is strictly limited to *a posteriori* control that the financial collateral agreement has been enforced in accordance with its terms and the law.

Pledge over shares

Security over shares commonly takes the form of a pledge. A pledge will only be enforceable if the possession of the shares has been transferred to the pledgee. Valid perfection of the pledge on shares is achieved as follows:

a book entry shares: a notice of pledge must be served on the custodian or registered in the custodian's account where the shares are deposited;

b bearer shares: the pledge must be registered in the register of bearer shares held by the depositary; and

c registered shares: the pledge must appear in the register of registered shares.

In most cases, pledge agreements over shares provide the ability for pledgees to use the rights attached to the shares (rights on distribution and dividends, voting rights) upon the occurrence of a triggering event defined by the parties. On such event, the pledgee can use the voting rights attached to the pledged shares to change the directors of their debtors and exercise an indirect and soft control on the assets. Upon the replacement of management, lenders generally enter into a standstill agreement with the newly appointed directors with the view to organising a smooth sale of the debtor's assets in the interests of all stakeholders.

Realising shares under a Luxembourg law pledge can be made through various methods, the most common being: (1) the direct appropriation by the pledgee; (2) the appropriation being made by a third party (generally an SPV) designated by the pledgee; and (3) the direct sale of the shares to a third party.

The appropriation (whether directly or through a designated SPV) can be made immediately, without notice, upon the occurrence of the agreed enforcement event. The appropriation must be made at a price fixed in accordance with the valuation method agreed between the parties; the valuation can always be made after the appropriation. This appropriation method serves the dual purpose of allowing immediate enforcement of the pledge (in a few minutes) and giving lenders the flexibility to appoint a third party to take control of the debtor without needing to become a shareholder.

A sale of the pledged shares must be made under normal commercial conditions. 'Normal market conditions' are not further defined by the Financial Collateral Law and the

Luxembourg court has had only one opportunity – in 2010[15] – to give an interpretation of this concept. In substance, the court considered that a sale under 'normal market conditions' would need to be concluded under conditions resulting from a free trade market at the time of realisation, taking into account the information available at the time of the realisation, the nature of the pledged assets and the specific outlines of the market. In the absence of a regulated market, the best offer is the offer available under the conditions applicable to the assets at stake.

Pledge over claims or receivables

A pledge over claims or receivables under a contract is perfected through the notification of the pledge to the debtor of the pledged claims or receivables, or its acceptance of the pledge. In practice, the debtor of the pledged claims or receivables is made a party to the pledge agreement to ensure immediate perfection of the pledge upon its execution.

Enforcement methods for a pledge over claims or receivables are similar to those available for the pledge over shares. In practice, the pledgee will step into the shoes of the pledgor by serving a notice to the pledgor that it has appropriated the relevant claim or receivable and will obtain direct payment in its hands.

Pledge over bank accounts

Under Luxembourg law, a security over bank accounts is materialised by a pledge over monetary claims (and not on the bank account itself). A pledge over bank accounts is validly perfected through the service of a notice of pledge to the bank where the account is opened and where the cash is credited, or when the bank has accepted the pledge.

In practice, the lenders will seek to obtain the bank's approval to release any of its priority rights on the bank accounts, which are generally granted under the bank's general terms and conditions.

Enforcement of a pledge over bank accounts is made upon the occurrence of an enforcement event by a notification to the bank. The pledgee will have the right to operate the bank account, request the transfer of all funds credited on the bank account or close the account.

Guarantees

Luxembourg law provides for specific personal security interest such as suretyships and guarantees on first demand.

A personal or joint guarantee will generally qualify under Luxembourg law as a suretyship. Unless expressly waived at the time the suretyship is granted, a guarantor benefits from various defences, allowing it to a certain extent to delay or deny the enforcement of its own obligations. Arguments generally invoked are the absence of default of the borrower, or the non-performance by the lender of its own obligations, or the invalidity of the (joint) guarantee.

A guarantor under a first-demand guarantee undertakes to pay a fixed amount to the beneficiary, irrespective of the obligations guaranteed. The payment obligation under a first demand guarantee is deemed abstract and autonomous. The guarantor is bound to pay the full amount it has agreed to guarantee and is deprived of the right to raise any defences with respect to the validity or enforceability of the obligations guaranteed.

15 Tribunal d'arrondissement de Luxembourg, 20 May 2010.

Mortgages on immoveable assets

The most common type of security on immoveable assets is the contractual mortgage, which must be made through notarial deed and registered with the Registration and Domains Authority. Contractual mortgages have a limited duration of 10 years, which is renewable.

ii Limitations

Legal specialty

A transaction concluded by a Luxembourg company must be made in compliance with company law and have a lucrative purpose.

Corporate purpose

The granting of security interest or guarantees must fall within the corporate purpose of the Luxembourg guarantor, which is set out in its articles of incorporation. Non-compliance with such corporate purpose may lead to the judicial cancellation of the agreement at the request of the counterparty, acting in good faith.

Financial assistance

Luxembourg public companies limited by shares (SAs) and companies governed by rules applicable to SAs[16] are not allowed to advance funds, grant loans or provide security for the acquisition of their own shares by a third party.[17] A breach of this financial assistance prohibition may result in civil and criminal liability for the parties involved in the transaction. The transaction may further be cancelled.

This prohibition does not apply to transactions undertaken by banks and financial institutions during their ordinary course of business, or transactions in which shares are acquired by, or for the benefit of, employees.

Financial assistance is allowed provided the company complies with the 'whitewash procedure', which requires, *inter alia*, that the transaction be carried out at fair market conditions, the company have distributable reserves in the amount of the financial assistance granted, and the transaction be approved by the shareholders, subject to a detailed published management report on the transaction.

Corporate benefit and guarantee limitation

In cross-border financing transactions, Luxembourg companies frequently provide security interests and guarantees to secure the obligations of their direct or indirect parent companies (upstream and downstream guarantees) or sister companies (cross-stream guarantees).

Lacking a definition of 'group of companies' in Luxembourg law whereby the interests of the group could override those of a single company, the validity of cross-stream or upstream guarantees will ultimately depend on a corporate benefit analysis by the grantor. In particular, the guarantor should have some individual interest (consideration) in the transaction and the expected benefit deriving from the guarantee should outweigh the risks taken in granting the

16 Corporate partnerships limited by shares and simplified joint-stock companies.

17 Article 49-6 of the Law dated 10 August 1915 on Commercial Companies (the Company Law).

cross-stream or upstream guarantee. The financial liability resulting from a guarantee should not exceed the financial capacity of the guarantor and, more specifically, should not send the guarantor into an insolvent position.

iii Clawback on insolvency

Transactions can only be clawed back or challenged in a bankruptcy. A clawback is initiated by the receiver and debated in court. Only specific transactions can be challenged.

Transactions entered into during the hardening period[18] may be declared invalid if they constitute the preferential satisfaction of one creditor over another.

The rights of creditors benefiting from a security governed by the Financial Collateral Law, even granted during the hardening period, are not affected by a bankruptcy or reorganisation proceedings and therefore remain enforceable.

The court can cancel the following transactions: disposals of assets without adequate consideration; payments made for debts not yet due; payments of due debts by means other than cash or bills of exchange; and granting of any security for a debt contracted before the hardening period.

Any payment for accrued debt or any transactions against money made after a company has ceased its payments and before the bankruptcy judgment may be cancelled by the court if the beneficiary of the payment or the contracting party was aware of the debtor's cessation of payments.

Mortgages granted during the hardening period (or 10 days before) may be cancelled if their registration was not carried out within 15 days of conclusion of the mortgage agreement.

As a general principle, payments made with the intention of defrauding creditors of their rights are void irrespective of the day on which they were made.

IV PRIORITY OF CLAIMS

i Preferred creditors

The following claims have statutory priority rights for reimbursement over the insolvency estate's creditors:

a judicial expenses (including bankruptcy receiver's fees);
b funeral expenses;
c fees and expenses for terminal illness; and
d public treasury claims and salary debts.

The Luxembourg Civil Code lists the claims benefiting from a general preferred right on a debtor's moveable or immoveable assets. These preferred rights supersede any security *in rem* granted to a creditor.

Securities granted to creditors over financial instruments or claims under the Financial Collateral Law remain enforceable despite the opening of a bankruptcy or reorganisation proceedings.

18 The period fixed by the Luxembourg courts up to six months before the bankruptcy judgement and up to 10 days before this period (Article 445ff of the Commercial Code).

ii Intercreditor and subordination agreements

For multijurisdictional syndicated facilities, the borrowers and the lenders will commonly enter into a foreign-law intercreditor agreement based on Loan Market Association (UK) standards. Such intercreditor agreement will determine the rights of each class of creditors (senior, mezzanine and junior) with respect to, in particular, their rank and subordination, the payments arrangements and the enforcement of security interests.

In mid-cap transactions or straight loans, the borrower's sponsors and the lenders will generally enter into a subordination agreement whereby the sponsors agree to the full subordination of their claims to the full repayment of the bank loan. In limited cases, the sponsors are entitled to certain 'permitted payments'.

Luxembourg law does not prevent creditors from agreeing on the rank of their respective claims. Case law and Luxembourg legal scholars recognise the validity of contractual subordination arrangements. Such agreements are effective towards third parties and courts would normally enforce them.

V JURISDICTION

i Choice of law and jurisdiction

Most financing transactions in Luxembourg are made by inbound foreign banks, financial institutions and professionals investors. Transactions tend therefore to be governed by the law that is most familiar to the financing parties, which is generally their own domestic law, for example English, New York, German or French law. Luxembourg security packages on Luxembourg located assets are generally governed by Luxembourg law.

Rules governing of choice of law for countries in the EU are determined by the Rome I Regulation[19] for contractual obligations and the Rome II Regulation for non-contractual obligations.[20]

The Luxembourg courts will generally recognise and apply the foreign law chosen by the parties unless the application of the foreign law would result in a solution manifestly incompatible with Luxembourg public policy or the courts are required to take into account overriding mandatory provisions of Luxembourg law.

Similarly, the submission by a Luxembourg company to the jurisdiction of a foreign court will be recognised as valid and binding on the company if it was made in good faith and with no intention of circumventing the mandatory provisions of Luxembourg or foreign laws.[21]

19 Regulation (EC) No. 593/2008 of 17 June 2008 on the law applicable to contractual obligations.

20 Regulation (EC) No. 864/2007 of 11 July 2007 on the law applicable to non-contractual obligations.

21 Regulation EU No. 1215/2012 of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters.

ii Enforceability of foreign judgment

In accordance with the Brussels Ibis Regulation,[22] any final and conclusive judgment rendered in another EU Member State will be immediately enforceable in Luxembourg without re-examination of the merits of the case.

Luxembourg courts may, however, refuse to recognise a foreign judgment if the recognition would be manifestly contrary to Luxembourg public policy or incompatible with an earlier judgment or if the defendant has been defaulting.

Other foreign judgments will be recognised and enforced in Luxembourg but require the filing of an *exequatur* procedure.[23] Luxembourg courts will make a deeper review of the foreign judgment and verify, notably, the enforceability of the foreign judgment in the jurisdiction in which it was rendered, the competence of the foreign court, the legal local procedures, the respect of the rights of defence, the law applied to the judgment, and the absence of fraud and violation of Luxembourg international public policy.

Regulation (EC) 805/2004 of 21 April 2004, creating a European enforcement order for uncontested claims, provides for the abolition of *exequatur* for judgments on uncontested claims.

VI ACQUISITIONS OF PUBLIC COMPANIES

Luxembourg regulations related to takeover bids or squeeze-outs may affect the financing of acquisition of Luxembourg companies listed on an EU or EEA-regulated market.

Under the Takeover Law,[24] an offeror must announce a bid only after ensuring that it can fully provide a cash consideration, if such is offered, and after taking all reasonable measures to secure the implementation of any other type of consideration. The offeror must therefore ensure that it has obtained the necessary financing from its lenders to cover the settlement of all the tendered shares. Preconditions to a bid are not permitted unless they are official authorisations or regulatory clearances. This entails that a bid must not normally be subject to any financing conditions or preconditions (other than regulatory clearances), and funds must be available to implement the bid.

The Luxembourg Squeeze-Out Law[25] came into force on 1 October 2012. This completes the Luxembourg legislation applicable to majority shareholders of listed companies in takeover bids. It further provides for a forced sale by minority shareholders when the majority shareholder holds 95 per cent or more of the share capital and voting rights of a quoted company.

According to the Takeover Law, if the enforcement of a share pledge by way of appropriation exceeds the threshold of one-third of the voting rights of the target companies, the lender will have to issue a mandatory bid to the remaining shareholders. Similarly, under

22 Ibid.

23 Article 678 of the New Luxembourg Code of Civil Procedure.

24 Law dated 19 May 2006 on takeover bids, as amended (the Takeover Law) implementing Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids into Luxembourg law.

25 Law of 21 July 2012 on mandatory squeeze out and sell-out of securities of companies currently admitted to trading on a regulated market.

the Squeeze-Out Law, if a lender enforces a share pledge by way of appropriation over a number of shares exceeding the threshold of 95 per cent of the voting rights and share capital of the target company, it may be required to purchase the shares of minority shareholders.

Under the Takeover Law, the bidder must disclose in its offer document all the information necessary to enable the holders of the offered company securities to reach a properly informed decision on the bid. This expressly includes information concerning the financing for the bid.

The CSSF remains the competent authority to control the compliance of the bidder with market transparency principles and ensure that the rights of securities of any company affected by the bid are protected.

VII OUTLOOK

New legislation will be coming into force in Luxembourg in 2016.

A law on the modernisation of company law was voted on by the Luxembourg parliament on 13 July 2016. This law will provide for more flexibility in the use of securities such as tracking shares, beneficiary units or convertible bonds. It also provides for the creation of a new form of company: the simplified joint-stock company, directly inspired by the French legislation.

The introduction of a new type of Luxembourg investment vehicle, the reserved alternative investment fund (RAIF) was also adopted by the Luxembourg parliament on 14 July 2016. The RAIF will be regulated under Directive 2011/61/UE of 8 June 2011 on alternative investment fund managers and will benefit from the corresponding EU passport, but will not be supervised by the CSSF.

Chapter 16

POLAND

Tomasz Kański and Borys Sawicki[1]

I OVERVIEW

Poland is the largest Central and Eastern Europe economy to have maintained growth over the past 25 years, even during the recent world financial crisis – in fact it was the only EU country that avoided a recession during the post-2007 global economic and financial crisis.[2] A positive macroeconomic environment and a well-developed, cost-effective labour market combined with a stable banking sector, leading stock exchange in the region (the Warsaw Stock Exchange), and a legal framework adjusted to European standards support the strengthening of Polish businesses and creates opportunities for investors.

In the final quarter of of 2015, the number of M&A transactions reached 77. The highest value of an M&A transaction on the Polish market in 2015 was €584 million[3] (the acquisition of a 52.7 per cent stake in TVN SA, a private television network). The number of deals in the first quarter of 2016 remained stable – at 46, very similar to the first quarter of 2015, when 50 deals were noted.[4] Experts indicate that the market has stabilised at a sound level.

It is also noteworthy that Polish companies in general are under-leveraged, and the overall corporate debt to GDP is quite low – on average twice as low than in other developed countries in Europe. This means that local banks have a lot of space to offer their capital for syndicated loans on the domestic market.[5] For example, in 2011 when Zygmunt Solorz-Żak decided to acquire the Polish telecom provider Polkomtel SA for 18 billion zlotys, he had

1 Borys Sawicki is a senior counsel and Tomasz Kański is a partner at Sołtysiński Kawecki & Szlęzak.

2 Country Report Poland 2016, The European Commission Brussels, 26 February 2016.

3 M&A Index Poland, 4Q 2015 by Navigator Capital & Fordata, January 2016.

4 M&A Index Poland, 1Q 2016 by Navigator Capital & Fordata, April 2016.

5 Global Capital, Poland in the Global Marketplace, May 2014.

to search for external funding of over 75 per cent of the total amount. The interest on the lender's side was so vast that reduction of the subscriptions for Mr Solorz-Żak's debt was more than 30 per cent.[6]

II REGULATORY AND TAX MATTERS

i Regulatory matters

The issue of regulated or non-regulated character of lending activity is disputable in Poland where law distinguishes 'credits' from 'loans'.

Granting 'loans' is not an activity restricted to banks and may be extended commercially also by non-bank entities;[7] however, should loans be provided by an EU credit institution, such institution should, in principle follow the EU passporting procedure ('lending' being one of the activities subject to mutual recognition under CRD IV and previous directives).

On the other hand, a commercial activity consisting in the granting of credits always requires a banking licence. A banking licence may be also passported from another EEA Member State.

The distinction between 'loan' and 'credit' is a technical one, and is based on certain specific features of these agreements. The prevailing view is that in the case of non-bank lenders, in order to avoid the qualification of conducting a banking business without the requisite licence, such entities' lending activities should, in principle, be financed out of their own funds.

ii Sanctions, anti-corruption and money laundering

Anti-corruption and money laundering are typically covered by the standard KYC (know your customer) procedures of the lenders. On the documentation side, these are addressed chiefly through representations and warranties (for the past and present time) as well as through covenants or undertakings (for the future), albeit the relevant provisions are usually not extensively drafted. This is at least in part because both issues are covered by applicable provisions of law, including, in particular, criminal regulations, which are perceived as complete and not requiring additional contractual support.

iii Tax matters

Acquisition financing used by a Polish resident triggers several tax issues in Poland, including, in particular, the following.

Withholding tax

Interest paid by the Polish borrower to a foreign lender being a Polish tax non-resident is subject to 20 per cent income tax to be withheld by the borrower. Where the foreign lender is a tax resident of the state that has concluded a double tax treaty (DTT) with

6 www.forbes.pl/artykuly/sekcje/Strategie/lewarowanie-po-polsku,20128,1#.

7 Some limited public supervision over non-banking consumer lending institutions results from a bill of legislative amendments adopted by the Polish Parliament in mid-2015. As of 11 September 2016, non-banking consumer lending institutions will be subject to, *inter alia*, minimum capital requirements.

Poland, the respective provisions of the DTT may apply, reducing the rate of withholding tax down to 15, 10 or even 5 per cent (depending on the applicable DTT). Several DTTs even provide a withholding tax exemption against interest (e.g., the DTT between Poland and France). Furthermore, under some DTTs the withholding tax exemption may apply towards financing granted by qualified lenders (e.g., banks). The favourable tax provisions of the DTT may be applied if the foreign lender's pertinent certificate of tax residency is provided to the Polish borrower.

If interest is paid to a foreign lender that is a tax resident of an EU Member State (or EEA), the withholding tax exemption under the domestic provisions implementing the 'interest royalties directive' may apply. The tax exemption requires the fulfilment of certain conditions (in particular, it applies to related 'mother' or 'sister' entities where at least a 25 per cent shareholding relationship has existed for at least two years). The application of the tax exemption may be applied if the Polish borrower is provided with (1) the relevant certificate of tax residence of the foreign borrower and (2) a written statement confirming that the foreign borrower does not enjoy an exemption from income tax on its worldwide income, wherever derived.

Interest deductibility

As a general rule, interest payable by the Polish borrower constitutes its tax-deductible costs. The cost is not deductible until such time as the interest has been paid or capitalised (accrued interest does not constitute a tax-deductible cost). Under general rules, a Polish tax borrower needs to demonstrate that the financing is related to its business activity (and therefore, the financing cost may be deducted as it is related to the source of revenue).

Thin-capitalisation rules

Under Polish tax law, the interest paid by a Polish borrower to its related lender may not constitute tax-deductible costs for the Polish borrower when thin-capitalisation rules (TC rules) apply. The TC rules apply only to the financing granted by qualified shareholders (i.e., a shareholder that directly or indirectly holds at least 25 per cent shares of the Polish debtor).

The interest paid is not tax deductible for the Polish borrower in the part that refers to the amount of financing granted by the qualified shareholders exceeding the total value of the Polish borrower's own capital (1:1 ratio). The definition of the financing for TC rules is very broad and also includes, for example, the issuance of bonds. The own capital of the Polish debtor to be calculated for TC rules purposes should include not only share capital but also other types of capital (e.g., supplementary or reserve capital).

Transfer pricing

Any kind of financing provided between related parties is subject to a transfer pricing regime on a general basis. The definition of the related parties for transfer pricing purposes is broad. In particular, it includes any 5 per cent direct or indirect shareholding relationships, as well as family or management relationships.

Such financing needs to follow arm's-length conditions (i.e., all conditions of the financing should be agreed on the fair market basis), otherwise, the Polish tax authorities may estimate tax burdens (for the lender or borrower or both) according to the conditions that they assess as falling under the arm's-length principle.

The financing granted between the related parties may also trigger an obligation to prepare specific transfer pricing documentation when the transaction exceeds the statutory threshold. The purpose of the documentation is to describe the details of the transaction and confirm that the financing represents market conditions. Failure to provide such documentation at the request of the Polish tax authorities may trigger additional tax burdens if the Polish tax authorities assess the financing as being inconsistent with the arm's-length principle.

VAT

As a general rule, financing should be classified as a financial service that benefits from VAT exemption under Polish VAT law.

Stamp duty

The financing granted under a loan agreement may be subject to 2 per cent stamp duty payable by the borrower; however, loans granted to a corporate borrower by its direct shareholders are stamp duty-exempt. A loan classified as a VAT financial service is also exempt from stamp duty. Classification of a loan as a VAT service requires that the loan is granted within the VAT-able business activity of the lender (i.e., it is not merely an incidental one-off non-business activity).

Stamp duty applies only to loans. Other forms of financing, for example, bonds issuance, are not caught by stamp duty.

III SECURITY AND GUARANTEES

i Composition of a standard security package and types of collateral given

A standard security package in a leveraged buyout acquisition most often consists of a combination of security interests, depending on the available collateral and commercial arrangements between the parties. Typically, registered pledges over shares or assets are backed by civil or financial pledges and coupled with assignments of receivables (account, insurance) and mortgages (if real properties are available). The package is usually strengthened by voluntary submissions to enforcement. We describe those typical interests further below.

ii Most common types of security given by borrowers

Pledge

A pledge is a right *in rem* and, as such, is effective as regards third parties. Polish law provides for three types of pledge: registered, financial and civil pledges.

Registered pledge

The registered pledge may be established over: (1) moveables (such as cars, machines); (2) transferable rights (e.g., shares, receivables); and (3) aggregate of moveables and rights (pledges over business). Real properties may only be encumbered with mortgages.

Such pledge is created by an agreement followed by mandatory entry into the publicly accessible, centralised Pledge Register. Upon entry into the Register, it enjoys priority over any registered pledges or other rights *in rem* subsequently created.

Usually, the registered pledge agreement contains negative pledge provisions, prohibiting the pledgor from further encumbering or disposing of the object of the pledge.

Civil pledge

A civil pledge is established by an agreement between the pledgee and the pledger.

The pledge agreement may not include negative pledge clauses, is not subject to registration and may be enforced only through standard court enforcement proceedings. Those features, combined with peculiar priority rules (a pledge established later enjoys, by operation of law, a higher priority than a pledge established earlier unless the pledgee of the later pledge acted in bad faith), result in the instrument being typically used as an interim security until registration of the pledge over the same asset.

Financial pledge

The financial pledge was introduced to the Polish legal system by the Act on Collateral Arrangements in Implementation of the EU Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements.

The main differences compared with the civil pledge are the limited number of entities that may act as a pledgee or pledgor under a financial pledge and the availability of out-of-court enforcement methods in addition to the standard court enforcement.

Similarly to the civil pledge, the financial pledge usually is used as an interim security until registration of the pledge.

Assignment of receivables as collateral security agreement

The assignment of claims is made by virtue of an agreement between the debtor and the creditor. Pursuant to the agreement, the debtor, as the assignor, assigns its receivables stemming from an underlying relationship to the creditor, as the assignee.

The assignment may concern a single receivable or pool of receivables, both existing and future. In some situations, an assignment may be prohibited by the law or contractual arrangements. Assignment of receivables from insurance agreements and commercial contracts (account receivables) are the most common types of the agreements discussed.

Mortgage

A mortgage is a right *in rem* effective as regards third parties. It is established over real properties and its registration in the publicly accessible Land and Mortgage Register is requisite for the instrument to come into force.

A mortgage entered into the Land and Mortgage Register enjoys priority over any mortgages or other rights *in rem* subsequently created over the subject real estate.

Declaration on voluntary submission to enforcement

A declaration on voluntary submission to enforcement is not strictly a security instrument, but it is very often included in the security package as it allows enforcement of claims by creditors to be accelerated as it replaces a court judgment awarding the claim.

By way of the declaration, made in a notarial deed, the debtor acknowledges its obligation to the creditor and undertakes to pay up to a specified amount (together with interest and other costs, as applicable) and submits to enforcement in respect of that payment obligation. Following the lapse of a deadline set out in the declaration or upon occurrence of the triggering events described therein (usually, payment default) the creditor becomes entitled to commence enforcement proceedings.

Promissory note

A promissory note is also not strictly a security instrument, but similarly to the declaration on voluntary submission to enforcement, it allows the acceleration of the enforcement of claims. The Polish regulation on promissory notes originates from the Geneva Convention on promissory notes from 1930 – thus, it is similar to the legal frameworks of most western European legal systems.

Surety

In a surety contract, a third party undertakes to repay the debtor's debt if the latter fails to do so. The liability of the person granting surety is joint and several with the debtor's unless otherwise provided in the contract. An important deficiency of the surety is that when the suretyship is granted in reference to a future liability, it may be established only up to a specified maximum amount and must be limited in time.

Guarantee

A guarantee is a granted by way of an agreement between the debtor and the creditor (the beneficiary of the guarantee). Since, unlike all security interests so far outlined, a guarantee arrangement is not expressly regulated under Polish law, the parties are free to structure it at their discretion, but within the limits of the freedom of contracting principle.

In a typical guarantee, the guarantor undertakes to unconditionally and irrevocably pay the creditor (as the beneficiary) the guaranteed amount upon the latter's first demand. The guarantee agreement will usually define the terms upon which the beneficiary may demand payment of the guaranteed amount.

Polish entities often provide guarantees (both under Polish and foreign law) to secure the obligations of their parent or sister companies). While providing the guarantee, Polish guarantors must, however, abide by some restrictions that limit the maximum number of liabilities they may guarantee. Also, their managers must duly analyse whether the granting of the relevant guarantee is in the interests of the grantor – Polish law does not recognise group interest as such.

Corporate benefit

Management board members of any Polish company are obliged to act in the best interests of that entity. They may be held liable (including criminally) for acting to the detriment of the relevant entity's interests, which could be the case when entering into transactions without proper consideration or that may have a material adverse effect on the existence or financial position of the entity, or both. The latter applies, in particular, to transactions that may result in the 'technical insolvency' (as outlined below) of the relevant company.

To mitigate the risk, the transaction documentation should provide evidence that the managers have diligently analysed the risk of insolvency of the parent company and, if applicable, of other entities whose obligations are to be secured, and that the guarantor received or will receive proper (arm's-length) consideration for providing the guarantee. Such 'proper consideration' does not necessarily mean that the company should receive consideration in cash – it is assumed that the term 'proper consideration' may be understood in a wider context and represent anything that represents real value to the company – such as access to intragroup financing provided on more beneficial terms than available on the market, or access to technology or know-how.

Technical insolvency – guarantee limitation language

Under Polish bankruptcy law, a company whose total value of liabilities exceeds the total value of its assets is deemed insolvent, even if it satisfies its debt in a timely manner (technical insolvency).

Recent amendments to the Polish bankruptcy law have, however, significantly lessened the relevance of the foregoing principle to transactions in which Polish entities provide guarantees. The period during which the value of liabilities must exceed the value of assets has now been extended to 24 months, and contingent liabilities (e.g., guarantees) have expressly been excluded from the definition of liabilities. As a result, under the current wording of the bankruptcy law, guarantees in finance transactions – which by nature are contingent liabilities – are unlikely to result in the technical insolvency of a guarantee provider (at least until they become due and payable, and remain so for a period exceeding 24 months). Following these changes, the relevant limitation clauses, which have been developed on the market to tackle the risk of technical insolvency, are likely to disappear from the transaction documentation or will be significantly restructured.

These changes to the Polish bankruptcy law are particularly beneficial for the creditors, who will no longer need to worry about the impact a limitation clause could have on the actual value of guarantees provided by Polish guarantors. In extreme cases, with a guarantee provider significantly indebted, the limitation clause (in its typical wording existing on the market since the introduction of the bankruptcy law in 2003) could render the protection under the relevant guarantee illusory.

Security agent issues

Polish law permits intercreditor agreements, in which the creditors indicate one of them as the security agent holding the security interests on behalf of the remaining creditors. Contrary to the Anglo-Saxon concept of a security agent, however, the Polish regulation is not universal and may be employed only in respect of specific types of security instruments, namely the registered pledge and mortgage. Moreover, even in those two situations, the concepts differ in details – under a registered pledge, the security agent must always be a creditor whereas there is no such requirement in the case of a mortgage.

As for other security interests (such as civil and financial pledges), it is not possible to appoint a security agent at all. The same applies to the voluntary submissions to enforcement as it is not possible to submit to enforcement in favour of a person that is not one's creditor.

Preference periods

Pursuant to Polish bankruptcy law, certain transactions effected by a debtor within a particular statutory period prior to the filing for bankruptcy are, or may be deemed, ineffective as regards the bankruptcy estate.

Legal actions pursuant to which the debtor has disposed of its assets (properties), performed within the year before the filing for declaration on bankruptcy are ineffective towards the bankruptcy estate (i.e., the assets or their equivalent should be returned to the estate) if performed gratuitously or for consideration with the value of the debtor's performance being blatantly in excess of that received by the latter.

Transactions towards the bankruptcy estate (even for consideration) between the debtor and its shareholders (direct or indirect) made in the six months before a motion for the declaration of bankruptcy of the debtor is filed (whichever motion is later granted) are also ineffective.

Payments by the debtor, made in the six months before any party files a motion to declare the debtor bankrupt (which motion is later granted) that at the time of their making had not been due and payable, will be ineffective towards the bankrupt's estate by operation of law. The same applies *mutatis mutandis* to the establishment of any security interest (including a pledge or a mortgage) by the debtor. Nevertheless, the recipient of the payment or security interest may file to declare the payment or establishment of the security effective, if at the date thereof it was not aware of the existence of the grounds for the declaration of the bankruptcy of the debtor.

The judge commissioner (a judge appointed to supervise the bankruptcy proceeding) may, at the request of a court receiver, court supervisor, administrator or *ex officio*, consider any encumbrance of the bankrupt's property ineffective towards the bankruptcy estate if the bankrupt was not the principal (direct) debtor on account of the secured claim. This is also the case if a security interest was established within the year before a motion for the declaration of bankruptcy was filed and in connection therewith, and the bankrupt received no consideration or virtually no consideration. In the case of a security interest established to secure a debt of the bankrupt's related party (e.g., parent company), the value of consideration is irrelevant.

IV PRIORITY OF CLAIMS

i Division of the bankruptcy estate

Receivables subject to satisfaction from bankruptcy estate funds are divided into the following categories:

a category one: employees' remuneration that became due before the announcement of bankruptcy (except for the remuneration of the representatives of the bankrupt), receivables personally connected with the bankrupt (as it may be applicable), including alimony due for three years prior to the announcement of bankruptcy, disability pensions, and receivables that arose from the bankrupt's (or the bankruptcy administrator's) actions taken after the announcement of bankruptcy;

b category two: taxes and public dues, as well as receivables not falling into any other category;

c category three: interest on receivables classified under higher categories, as well as court fines, donations and testament endows; and

d category four: receivables of shareholders under loans and other similar agreements, in particular, deliveries with postponed payment made within the five years before the announcement of the bankruptcy, together with interest.

Before the receivables from any category are satisfied, the bankruptcy estate must first settle the cost of the bankruptcy proceeding and alimony (if applicable) due for the period after the announcement of the bankruptcy. If the funds of the bankruptcy estate are sufficient to cover these sums, other receivables are satisfied category by category. This means that, for example, a receivable from category two may be satisfied only if all submitted receivables from the category one have been already satisfied. The same applies to further categories (three and four). If the assets do not suffice to satisfy all the receivables of the same category, those remaining receivables are satisfied in proportion to the amount of each of them.

ii Secured claims

Receivables secured by a mortgage, pledge, registered pledge are subject to satisfaction from the amount gained from the liquidation of the encumbered object, less the costs of the object's liquidation and other costs of bankruptcy proceedings in an amount not exceeding one-tenth of the amount gained from liquidation. This must not be more, however, than that portion of the costs of bankruptcy proceedings following from the proportion of the encumbered object against the value of the entire bankruptcy estate. The costs of proceedings are taken into account last. Amounts gained from liquidation of things, receivables and rights encumbered by a mortgage, pledge, registered pledge, treasury pledge and marine mortgage are allocated for satisfaction of creditors whose receivables were secured on these things or rights, in compliance with the provisions of the Polish Bankruptcy Law. Amounts remaining after satisfaction of these receivables become part of the funds of the bankruptcy estate and are subject to division in accordance with the general rules described above.

V JURISDICTION

i Submission of disputes to foreign jurisdiction

Generally, Polish law enables the submission of disputes arising out of, or in connection with, an agreement signed by a Polish company to the exclusive jurisdiction of courts of a foreign country. In this case, two regimes may be recognised – one applicable to the choice of jurisdiction made in favour of a court based in another EU country, and the other, applicable to courts of non-EU countries.

In the first case, the Regulation (EU) No. 1215/2012 of the European Parliament and of the Council of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (recast)[8] indicates the terms upon which the choice of jurisdiction is applicable. Thus, the terms under which the submission of disputes to foreign jurisdiction apply does not differ between EU countries.

In the case of the choice of a non-EU forum, Polish law allows the exclusion of the jurisdiction of Polish courts in favour of courts of a foreign state provided that: (1) the selection is made in writing; (2) the choice of foreign jurisdiction is valid under the law of the chosen forum; and (3) the pertinent matter does not belong to the exclusive jurisdiction of Polish courts.

ii Enforceability of foreign judgments

A court judgment of an EU country shall be recognised or, as the case may be, declared enforceable by a Polish court without review of its merits pursuant to the applicable provisions of Regulation (EU) No. 1215/2012 of the European Parliament and of the Council of 12 December 2012.

Judgments of foreign courts other than courts of the EU countries are recognised and declared enforceable in Poland on the basis of reciprocity as long as the judgment does not fall under any exception indicated in the law.

8 Official Journal L351/1.

iii Submission and enforcement of arbitration awards

Agreements submitting disputes related to the financing transactions are common in Poland. Submission to arbitration should be made in writing and must specify the subject matter of the dispute or the legal relationship from which a dispute has arisen or may arise.

Poland is a party to the New York Convention to the extent that Article II of the foregoing convention requires contracting states to recognise arbitration agreements. Arbitral awards rendered pursuant to the arbitration clauses contained in the agreement executed with an entity from a country that has also signed by New York Convention will be enforceable in Poland in accordance with the terms of the New York Convention.

It is worth noting that, pursuant to Polish bankruptcy law, arbitration clauses expire upon declaration of bankruptcy of one of the parties thereto, and the arbitration proceedings conducted by such party will cease as of that moment.

VI ACQUISITIONS OF PUBLIC COMPANIES

i General overview of de-listing of a public company

In order to delist the company (i.e., exclude its shares from trading on the stock exchange), a relevant resolution of the Warsaw Stock Exchange management board must be adopted. Further, shares may be subject to delisting if, within the past three months, no exchange transactions have been effected with respect to them.

A shareholder intending to delist the company should first acquire all shares of a public company via a mandatory public tender bid. This obligation does not arise if all shareholders agree on delisting of the company.

The investor intending to delist a public company must possess enough funds for the tender price. These funds may be covered by a loan – leveraged financing of such transaction is not precluded.

ii Mandatory tenders

In general, the direct acquisition of shares in a public company may only occur via a tender bid for an exchange or sale of shares if they result in:

a more than 10 per cent of the total votes, in less than 60 days, being acquired by an entity holding less than 33 per cent of the total number of votes; or

b more than 5 per cent of the total votes, in less than 12 months, being acquired by a shareholder holding a number of votes equal to at least 33 per cent of the total number of votes.

However, a compulsory tender is precluded if creditors secured by either registered or financial pledges forecloses the ownership of the pledged shares.

iii Minority squeeze-outs

A shareholder of a public company holding at least 90 per cent of the total number of votes (individually or acting in concert with other entities) is entitled to demand that all other shareholders sell all their shares held in a public company. The minimum share price must be no lower than the three-month market average price for shares (which in some circumstances may be further increased in accordance with the provisions of the Polish Public Offer Act). Acquisition of the shares by way of a squeeze-out does not require the consent of the shareholder to whom that demand is addressed. A squeeze-out is announced after providing collateral not lower than 100 per cent of the value of the squeezed-out shares. Withdrawal from a squeeze-out that has already been announced is prohibited.

VII OUTLOOK

It appears that thanks to continuous growth of the Polish economy in recent years, there are still good opportunities for leveraged finance acquisitions in Poland. Even after adding about 20 per cent to its GDP over the past five or six years, Poland's projected annual growth of about 3.7 per cent this year makes it an attractive market for inflows of investment on a risk-adjusted basis.[9]

Although there are currently not many state-owned companies that may still be subject to privatisation, more Polish privately owned companies are expected to be available for acquisition. As Poland has spent 25 years as a free-market economy, many business founders are reaching retirement age. In cases where no succession is feasible, they will most likely decide to sell and cash in. Also, the Polish equity market remains modest by the standards of developed markets.

Lately, however, innovative and fast-growing start-ups have also become more common. Only recently, one of Poland's newest start-ups, offering shared office space, achieved a valuation of €7 million in only three months, becoming one of the most successful newcomers in Europe.[10] The new Polish government has decided to support Polish entrepreneurs by launching a 3 billion-zloty incentive plan aimed at helping high-tech start-up companies.[11] Simultaneously, there are additional smaller-scale programmes targeted at particular markets – for example, a special programme supporting Polish computer game developers.[12] Undoubtedly, this relatively new trend in the market should create solid grounds for many takeovers in coming years when the young investors commence seeking additional funding or decide to simply cash in their ideas.

9 http://ec.europa.eu/economy_finance/eu/countries/poland_pl.htm.

10 www.rp.pl/Biznes/303219910-Polski-start-up-wsrod-najdrozszych-w-Europie.html#ap-2.

11 http://businessinsider.com.pl/strategie/male-firmy/program-start-in-poland-to-dofinan sowanie-dla-startupow/0xpbnwj.

12 http://wyborcza.biz/biznes/1,147881,19936301,arp-wchodzi-w-polskie-gry-wideo-rzad-bedzi e-wspierac-tworcow.html.

Chapter 17

PORTUGAL

Gonçalo Veiga de Macedo and Edgar Monteiro[1]

I OVERVIEW

Following the bailout by Europe and the IMF in 2011, Portugal continues to be a country with significant levels of debt, ranging close to 130 per cent of GDP, one of the highest levels in the eurozone. The local banking sector continues to face significant challenges and, following the recent resolution measures applied by the Bank of Portugal to two Portuguese banks,[2] it has been announced that the country's largest state-owned bank requires emergency recapitalisation.

The combination of slow growth and a fragile banking sector has led to a number of deals spurred by the pressing need by companies and the financial sector to reduce debt levels by way of disposals. As a result, international rather than domestic banks have been lending to international investors to fund the acquisition of companies and assets.

Leveraged acquisition financing structures involving significant Portuguese companies tend to be governed by English or US law given the origin of the lenders and investors. Traditional senior and mezzanine financings, made available by players active in the European banking market, are still common as the use of more structured deals increases as a result of tax and regulatory constraints of lending directly into Portugal, and where new alternative credit providers fund part of the acquisition.

1 Gonçalo Veiga de Macedo is a counsel and Edgar Monteiro is an associate at Linklaters LLP.

2 On 3 August 2014 the Bank of Portugal applied a resolution measure to Banco Espírito Santo SA, whereby its general activity and assets were transferred to Novo Banco, a bridge bank. On 20 December 2015 the Bank of Portugal applied another resolution to Banif – Banco Internacional do Funchal SA, where it transferred part of the assets and liabilities of such bank to Banco Santander Totta SA and to a separate management company incorporated for such purpose.

Given its cultural and historical link with lusophone African countries, Portugal will continue to be a significant jurisdiction and initial signs show bank-led deals progressing to more complex financing structures, including leveraged acquisitions.

II REGULATORY AND TAX MATTERS

i General regulatory requirements

The Portuguese Banking Regulations, enacted by Decree Law No. 298/92 of 31 December, provide that the making of loans is exclusive to and can only be performed on a professional basis by regulated financial institutions.

The concept of performance 'on a professional basis' is not defined in law, but the accepted view is that the making of loans and the assumption of obligations in relation to undrawn loans and revolving facilities, if made in Portugal, require that the lenders be:

a financial institutions holding a licence from the Bank of Portugal;

b financial institutions holding an EEA-passported licence (in the case of EU institutions) or Portuguese branches of those financial institutions; or

c Portuguese branches of non-EEA financial institutions, which are authorised by the Bank of Portugal.

Portuguese law does not specifically address situations in which loans are deemed to have been made (or when undrawn loans or revolving facilities are deemed to have been made available) in Portugal; neither are there any official recommendations or opinions issued by the Bank of Portugal (in its capacity as the market supervisor) or case law from the Portuguese courts in this respect. Analysis on a case-by-case basis is therefore advisable.

ii Sanctions and anti-money laundering

Portugal follows the sanctions imposed by the Security Council of the UN and by the EU authorities under the Common Foreign and Security Policy.

As for anti-money laundering, Portuguese law includes requirements that stem from the EU directives on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing. Please note, however, that Portugal has not yet transposed the Fourth Anti-Money Laundering Directive.

iii Tax matters

Deductibility of interest

The Portuguese Corporate Income Tax Law has no rules on thin capitalisation, but transfer-pricing rules may affect the deductibility of financing expenses where arm's-length conditions are not observed.

In addition, net financing expenses exceeding the higher of 30 per cent of the EBITDA[3] or €1 million are not deductible, although both the excess and the unused margin up to the relevant threshold may be carried forward for five years.

3 Transitionally, 40 per cent in 2016, 30 per cent from 2017 onwards.

Withholding tax

Withholding tax is generally payable under Portuguese law on interest and fees (other than for financial services) due from a borrower resident in Portugal for tax purposes to any lender resident outside Portugal for tax purposes. The domestic withholding tax rate is currently 25 per cent. This rate can be reduced by up to 10 per cent under double taxation treaties, provided that the tax residence of the lender is duly attested.

Certain exemptions apply to the payment of withholding tax, including:

a interest and fees payable by Portuguese banks or other qualifying financial institutions to a foreign lender qualifying as a financial institution;

b interest and fees payable by Portuguese branches of foreign banks or other qualifying financial institutions to a foreign lender qualifying as a financial institution;

c interest on bonds issued by a Portuguese borrower and payable to a foreign lender, provided such bond holder is a tax resident in a country that has entered with Portugal into a double taxation treaty or an agreement for exchanging information on tax matters, and for as long as the bonds are registered in a qualifying clearing system; and

d interest on bonds issued by a Portuguese borrower and payable to a foreign bond holder, provided such bond holder has no permanent establishment in Portugal and is not tax resident in any jurisdiction included in the list of tax havens issued by the Portuguese Ministry of Finance, and for as long as the bonds are registered in a qualifying clearing system.

There are two lending structures that are sometimes used in the Portuguese market to prevent the liability for withholding tax by taking advantage from the abovementioned exemptions. First, back-to-back funding structures may be used, whereby a foreign lender funds a Portuguese bank, which then makes the loan to the borrower. Although used in the past, this sort of structure may well be successfully challenged by the Portuguese tax authorities pursuant to the Portuguese tax law general anti-avoidance rule. Moreover, back-to-back structures necessarily give rise to counterparty risk and additional transactional costs.

Alternatively, a bond-loan structure can be used, whereby the loan is made by way of a bond issuance, which is subscribed for by the original lenders. Instead of using the terms and conditions common in capital markets transactions, the terms and conditions of these bonds will typically include provisions that are akin to standard loans, particularly those concerning covenants and events of default.

Nonetheless, adaptations are required to the language used in various provisions and there are certain limitations as to how far it is possible to emulate in a bond issuance the terms and conditions applicable to standard loans, in view of the fundamental conceptual differences between contracts and securities. Moreover, the use of a bond-loan structure gives rise to certain additional transactional costs, such as the fees charged by the clearing system and by the paying agent appointed by the borrower.

Stamp duty

Stamp duty can be a significant cost in financings in the Portuguese market. Stamp duty is due on loans made to a borrower resident in Portugal, as well as on loans made by a lender resident in Portugal, unless the specific loan is exempt. The exemptions from stamp duty on loans are very limited and mostly relate to loans between financial institutions or by certain multilateral development banks. A borrower is resident in Portugal for this purpose if it has its registered office, or is acting through a branch or other permanent establishment, in Portugal. Stamp duty is calculated by reference to the amount of the loans.

Note that neither bonds nor interest paid thereon are subject to stamp duty. As such, in addition to the matter of withholding tax payment, the use of bond-loan structures may also be more tax efficient from a stamp duty perspective.

Stamp duty may also be due on guarantees and security granted by or to an entity that is resident in Portugal and on security granted over Portuguese assets. A guaranteed or secured party is resident in Portugal for this purpose if it has its registered office, or is acting through a branch or other permanent establishment, in Portugal, and the same criteria apply in principle to determine whether a guarantor or security provider is resident in Portugal.

Portuguese assets include real property in Portugal, moveable property physically located in Portugal at the time the security is taken, shares or equity stakes (*quotas*)[4] in Portuguese companies, bank accounts held with Portuguese banks or Portuguese branches of foreign banks, and receivables owed by Portuguese companies.

Also, even if no stamp duty is initially due because a guarantee or security interest is deemed granted outside Portuguese territory, stamp duty may be due later if the relevant guarantee or security interest is enforced in Portugal or the documentation for such is presented in Portugal for any legal purposes.

Notwithstanding the above, if a guarantee or security interest is granted to guarantee or secure a loan in relation to which stamp duty is payable, and provided the documents whereby the relevant guarantee or security are granted are executed on the same day as the relevant loan documentation, then no stamp duty is payable on that guarantee or security. Similar to the position regarding loans, other exemptions are very limited and mostly relate to security or guarantees between financial institutions or to certain multilateral development banks.

Stamp duty is also payable on interest and fees or commissions in relation to financial services (e.g., arrangement, agency and commitment fees) and is calculated by reference to their amount at a rate of 4 per cent or, in the case of fees or commissions due in relation to the issuance of bank guarantees, at a rate of 3 per cent.

As a matter of law the lender, guarantors and security providers are primarily liable for paying stamp duty, although the economic burden falls on the borrower.

III SECURITY AND GUARANTEES

i Shared security

Portuguese law does not recognise the concept of trusts. Furthermore, it is doubtful whether parallel debt structures are valid and enforceable under Portuguese law, even if included within an English law document. As such, subject to the exception of financial collateral arrangements, it is not possible for a security agent to hold security on behalf of lenders.

Without prejudice to the foregoing, it is still possible to have a security agent acting on behalf of lenders, provided it does so in the capacity of attorney. This makes it possible

4 The two most common types of company in Portugal are companies limited by shares (*sociedade anónima*) and companies limited by quotas (*sociedade por quotas*). In the case of the latter their capital is represented by equity stakes (quotas), which are not securities but instead equity stakes of variable value registered with the companies registry.

that only the security agent executes security documents and ancillary documentation such as notices. Nonetheless, this does not mean that the security agent holds the security on behalf of lenders, as legal title to the security is still held by the lenders individually.

ii Financial assistance

Portuguese law expressly prohibits financial assistance. The prohibition applies to loans, guarantees, security or any other form of advance of funds by a company for the (direct or indirect) acquisition or subscription by a third party of shares representing its issued share capital. All transactions that breach the financial assistance prohibition are null and void.

The Companies Code is not entirely clear on whether the financial assistance prohibition also applies to companies limited by quotas and there is some debate among commentators on this issue.

There are two exceptions to the financial assistance prohibition: the prohibition does not apply to transactions concluded by banks and other financial institutions in the normal course of business, nor to transactions effected with a view to the acquisition of shares by or for the company's employees or the employees of an associate company.

Portuguese law does not set out any procedure to circumvent the financial assistance prohibition such as a whitewash procedure. As such, in acquisition finance transactions with Portuguese targets, it is market practice to include limitation language in relation to the liabilities guaranteed or secured by Portuguese companies so as to exclude any liabilities in relation to the funds used for the purpose of acquiring the target shares.

iii Limitations on security and guarantee

A company is only legally able to provide guarantees in relation to obligations of other companies if either (1) those companies are in a control or group relationship with the guarantor company or (2) the guarantor company directly or indirectly benefits from the provision of the guarantee.

In order to have a group relationship, a company must have held, directly or indirectly, the whole issued share capital of another company and it continues to hold at least 90 per cent of that other company's issued share capital. Group relationships also extend to cover sister companies that fulfil the foregoing criteria.

A control relationship will *prima facie* be deemed to exist if a company directly or indirectly holds more than 50 per cent of the issued share capital of the controlled company, holds more than 50 per cent of the voting rights of the controlled company or is able to appoint the majority of members of the management or audit bodies of the controlled company.

The concepts of control or group relationship only apply in relation to the obligations of companies with their head office in Portugal. If the company whose obligations are guaranteed is a foreign company, regardless of whether it is in a control or group relationship, it will be necessary that the guarantor directly or indirectly benefits from the provisions of the guarantee in order for it to be valid.

There is no objective corporate benefit test applicable under Portuguese companies law. The direct or indirect benefits for a company from the provision of a guarantee must be considered by the directors of the guarantor company on a case-by-case basis. Therefore, the existence of corporate benefit is primarily a commercial matter and in the first instance is decided by the board of directors or management (as applicable) of the guarantor company.

There is no legal limitation on the amount that can be guaranteed by a company, although it may be difficult to justify the existence of corporate benefit for a Portuguese guarantor company where enforcement of the guarantee is reasonably likely to result in the insolvency of the company.

iv Security

The most typical types of security interest in the Portuguese market are mortgages over real property, pledges over shares or equity stakes (*quotas*), bank accounts and receivables. Portuguese law does not recognise the concept of a floating charge or blanket security agreement covering all or most of the assets of a company. Therefore, a separate security interest must be created in respect of each specific asset over which security is to be taken.

Transfer of possession of chattel or moveable property is generally required for security to be valid and enforceable unless the relevant asset is subject to registration. However, a special legal regime known as banking pledge applies to security granted in favour of banks and other financial institutions, pursuant to which security over non-registerable chattel or moveable property may be granted without transfer of possession.

Portuguese law allows for the granting of security in relation to future or conditional liabilities; however, such liabilities must be determined or determinable (according to objective criteria) at the time the security is granted (e.g., any and all liabilities arising with regard to a specified entity).

Registration requirements vary according to the type of assets and not all security interests require registration. In relation to the assets most commonly secured, the following requirements and rules apply as regards registration with public registries:

a security over real property must be registered at the Land Registry, being a requirement for the creation of the security interest; and

b security over equity stakes in companies limited by quotas should be registered at the Companies Registry, being a requirement for the perfection of the security interest.

In both cases, the priority of the security will be determined by the time the request for registration is lodged.

The perfection of security over shares may require registration with the issuers of those shares or the financial intermediaries where the shares are deposited or registered.

IV PRIORITY OF CLAIMS

Insolvency claims are split between claims over the insolvency estate and claims over the insolvency.

Claims that arise from the insolvency adjudication and after the insolvency – claims over the insolvency estate – rank senior to all other credits over the insolvent party, and must be paid as they fall due from proceeds recovered during such proceedings. These include the insolvency administrator's fees, court costs, and debts arising from contracts performed after the adjudication of insolvency.

Claims that have their respective cause prior to the insolvency adjudication – claims over the insolvency – are ranked as follows:

a senior creditors: holding either secured claims (mortgages, pledges and other security that may be considered rights *in rem*) or claims benefiting from preferential ranking arising from the operation of law (typically, taxes and social security charges), up to the amount equal to the value of the secured assets and taking into consideration any potential prevailing liens;

b ordinary unsecured creditors: holding claims that are neither secured or privileged nor subordinated; and

c subordinated creditors: holding claims subordinated by agreement (e.g., as a result of an intercreditor or a subordination agreement), claims held by specially related persons, claims arising out of shareholder loans and claims arising out of interest accrued after the insolvency adjudication.

This ranking of claims is relevant both to determine the extent a creditor can vote in the insolvency proceedings (subordinated creditors will not be given the opportunity to vote in most of the resolutions to be taken by the creditors meeting) and the recovery rate of their credits.

According to Portuguese insolvency law, all assets and rights should be included in the insolvency estate, with the exception of any assets that were the object of financial collateral arrangements.

V JURISDICTION

Subject to Portuguese public policy, choice-of-law clauses in loan agreements will be recognised and enforced by the Portuguese courts, provided such choice of law is made in accordance with the Rome I Regulation.[5] Foreign judgments issued by the courts of countries that are subject to the Brussels Regulation[6] or party to the 1968 Brussels Convention or the 1988 Lugano Convention will be recognised and enforceable by the Portuguese courts without review of their merits, subject to the terms of that Regulation or that Convention, as applicable.

As for judgments issued by the courts of other countries, the procedure for recognition of foreign judgments set out in the Civil Procedure Code will apply, unless another procedure is established in an international treaty to which Portugal is a party. Examples of countries with which Portugal has bilateral international treaties on the enforcement of judgments are Angola, Brazil, Cape Verde and Mozambique. The standard procedure set out in the Civil Procedure Code is brought before the Portuguese appeal court with jurisdiction over the area in which the defendant is domiciled. Judgments should in principle be recognised by the court provided that, in the case of corporate defendants:

a there are no doubts as to the authenticity of the document in which the foreign judgment is recorded and as to the terms of the decision that was rendered;

b the foreign judgment cannot be subject to further appeal pursuant to the laws of the country in which the judgment was issued;

c the foreign judgment was awarded by a court whose jurisdiction has not been determined as a result of evasion of the law;

d the foreign judgment does not refer to matters subject to the exclusive jurisdiction of the Portuguese courts;

5 Regulation (EC) No. 593/2008.

6 Regulation No. 44/2001, recast by Regulation (EU) No. 1215/2012.

e no defence is available based on the existence of pending proceedings or of a previous final judgment on the same matter, in either case in proceedings held in a Portuguese court and which were started prior to the foreign proceedings;
f service of process in relation to the foreign proceedings was duly made pursuant to the laws of the country in which the judgment was issued;
g the principles of equal footing and right of defence were applied in the foreign proceedings; and
h the foreign judgment is not contrary to public policy.

Foreign arbitral awards issued in countries that are party to the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards will be recognised and enforceable in Portugal without review of their merits, subject to the terms of that Convention. As for arbitral awards issued in other countries, a procedure similar to that set out in the Civil Procedure Code for the recognition of foreign judgments is required, unless another procedure is established in an international treaty to which Portugal is a party. This is the case because in its ratification of the aforementioned Convention, Portugal made express reservation for the application of the principle of reciprocity.

VI ACQUISITIONS OF PUBLIC COMPANIES

While there are no fundamental differences between loan documentation for private-to-private and public-to-private transactions, there are certain features of Portuguese law applicable to tender offers that it is important to consider when structuring transactions.

The matter of certainty of funds is particularly onerous in the context of Portuguese tender offers. This is because the bidder is required to deposit the amount of, or provide a bank guarantee in relation to, any part of the price to be paid in cash. The regulator has some discretion to appraise the precise terms of bank guarantees delivered for this purpose and, therefore, the matter must be considered on a case-by-case basis.

Mandatory offers may be required if an entity directly controls more than one-third, or indirectly controls more than half, of the voting rights in a public company. This may occur as a result of the taking of security (if the pledgee is awarded the voting rights) or of enforcement of security.

Squeeze-out regimes are foreseen under Portuguese law for both private and public companies. In the case of the latter, this is generally possible if, following an initial public tender, the bidder acquires at least 90 per cent of the target shares and, as a result, ends up in control directly or indirectly of at least 90 per cent of the voting rights in a public company. The time frame to exercise the right of squeeze-out is three months after the initial bid. If the bidder does not meet the foregoing criteria to squeeze out the minority shareholders in the public company, it may still be possible to force a sale by first making the relevant company private.

Tender offers may be subject to conditions, provided these relate to legitimate interests of the bidder and do not affect the normal functioning of the market. Again, the regulator has some discretion to appraise the validity of the proposed conditions; however, the regulator cannot validate a condition the verification of which is controlled by the bidder.

Statutory confidentiality requirements apply until such time as the preliminary announcement of a tender offer is published. These extend to cover the lenders to the bidder.

VII OUTLOOK

In a context of some financial difficulties for local banks, which remain undercapitalised and are still engaged in deleveraging processes, alternative financiers and financing structures are likely to play a key role. In particular, in recent months the market has seen a sensible increase in the number of financings arranged and made by foreign or non-regulated lenders, a tendency that will likely continue.

Meanwhile, the Portuguese authorities are engaged in the recapitalisation process of the state-owned and largest bank in asset size, as well as in the finding of solutions acceptable for the EU institutions in order to assist in boosting local banks' capital buffers and recapitalising local businesses, including large corporates and SMEs. Thus, while the restrictions of EU law on state aid and the Portuguese government's own financial situation impose significant constraints on these processes, it is likely that the coming months will also see new policies and legislation being adopted with this aim. Possible developments include the reduction or elimination of restrictions on corporate lending by non-regulated financial institutions, as well as easement of the restrictions on the ability of the treasury and social security authorities to participate in debt restructurings in the context of insolvency or pre-insolvency procedures.

Chapter 18

RUSSIA

Mikhail Turetsky and Ragnar Johannesen[1]

I OVERVIEW

Although acquisition and leveraged finance is not a new concept for the Russian market, sophisticated Western-style financing transactions involving multiple layers of debt and a bond component remain unusual. Although a number of such transactions have been attempted over the years, the number of completed transactions remains relatively low. This is partly due to the limitations inherent in Russian law which historically has lacked many of the features required to structure complex secured financings, including inter-creditor arrangements.

However, a number of significant amendments have recently been introduced into the Civil Code[2] and certain related laws (together, 'amendments'). The amendments represent a significant step forward for sophisticated financing transactions in Russia as they expand the arsenal of instruments and options available to lenders, borrowers and issuers of debt securities. There have been several series of amendments relating to contractual obligations, security, corporate governance matters and insolvency.[3] Importantly, the amendments give creditors

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2 Part 1 of the Civil Code of the Russian Federation No. 51-FZ dated 30 November 1994, as amended, Part 2 of the Civil Code of the Russian Federation No. 14-FZ dated 26 January 1996, as amended, Part 3 of the Civil Code of the Russian Federation No. 146-FZ dated 26 November 2001, as amended, and Part 4 of the Civil Code of the Russian Federation No. 230-FZ dated 18 December 2006, as amended.

3 Federal Law No. 367-FZ 'Amending Part I of the Civil Code of the Russian Federation and Providing for Expiry of Certain Legal Acts (Provisions of Legal Acts) of the Russian Federation' dated 21 December 2013; Federal Law No. 99-FZ 'Amending Chapter 4 Part I of the Civil Code of the Russian Federation and Cancellation of Certain Provisions of Legal Acts of the Russian Federation' dated 5 May 2014; Federal Law No. 42-FZ 'Amending of Part I of the Civil Code of the Russian Federation' dated 8 March 2015; Federal Law No. 432-FZ

and pledge holders the right to agree certain subordination and priority arrangements among themselves. This new feature is likely to pave the way for further developments, including multi-layered debt in the context of leveraged finance transactions.

Since March 2014 the Russian market has been affected by the events that have been unfolding in Ukraine and the associated sanctions introduced by the US, the EU and others. Although it is too early to speculate about how the current situation will develop or what the long-term effect may be, it can certainly be seen that it has had an impact on market sentiment. Although trade and investment with Russia are not restricted generally, certain Russian persons (including major banks and oil companies) have become the subject of sanctions, and cannot therefore access long-term finance. That said, the current sanctions are perceived as being relatively limited in scope. The recent deterioration in the price of oil (Russia's key export) has also affected the number of transactions that are coming to the market. Although deal volumes are down, transactions are still being completed successfully and Chinese banks have to a certain extent filled the gap caused by Western banks adopting a cautious, 'wait and see' position. Recent examples include Uralkali, which obtained a US$1.2 billion facility from a number of international banks (including Bank of America Merrill Lynch, Citibank, Commerzbank and Deutsche Bank) and RUSAL's US$415 million loan facility from nine international banks (including Intesa, Nordea, Raiffeisen, UniCredit and Bank of China).

II REGULATORY AND TAX MATTERS

i Licensing

The Russian banking sector is regulated by the Banking Law.[4] Pursuant to the Banking Law, every Russian bank shall at all times hold a valid licence from the Central Bank of Russia (CBR). Foreign banks cannot obtain CBR licences, so most operate in Russia through Russian subsidiaries or representative offices that have obtained such licences. As of 2016, the CBR has the right to refuse the registration and licensing of a bank with non-Russian shareholders if, as a result of such registration and licensing, the aggregate percentage of foreign investment into the share capital of such bank would exceed 50 per cent.[5]

If an entity only acts as a lender or an agent in connection with financing transactions, but does not otherwise engage in banking activities that are regulated by the Banking Law (such as accepting deposits from or providing loans to consumers), then, subject to compliance with certain conditions set out in the Banking Law, such entity does not need a banking licence.

Accordingly, in practice, it is possible for foreign banks to participate as lenders or agents (including security agents) in connection with acquisition and leveraged finance

'Amending and Providing for Expiry of Certain Legal Acts (Provisions of Legal Acts)' dated 22 December 2014; and Federal Law No. 210-FZ 'Amending and Providing for Expiry of Certain Legal Acts (Provisions of Legal Acts)' dated 29 June 2015.

4 Federal Law No. 395-1 'On Banks and Banking Activity' dated 2 December 1990, as amended.

5 Federal Law No. 372-FZ 'On Amending Articles 16 and 18 of the Federal Law 'On Banks and Banking Activity' dated 14 December 2015.

transactions in Russia without a licence. Likewise, intra-group loans and on-loans (whether of acquisition finance proceeds or otherwise) among members of the obligor group can also be provided without a licence.

ii Anti-money laundering and anti-corruption rules

After becoming a member of the Financial Action Task Force on Money Laundering, Russia enacted the AML Law,[6] which implements anti-money laundering and 'know your client' (KYC) principles. Pursuant to the AML Law, Russian banks and foreign entities conducting monetary transfers in Russia are required to obtain certain information relating to their counterparties and their beneficiaries and to report (and refrain from participating in) 'suspicious' transactions. An entity conducting the transfer is required to conduct KYC checks in respect of all parties (including the seller under an acquisition financing, irrespective of whether the seller is a party to the finance documents).

The Anti-Corruption Law[7] contains a broad definition of what constitutes corruption, and includes both state and commercial bribery. For the purposes of the Criminal Code,[8] bribery is a crime and, over the past 10 years or so, Russian legislators have repeatedly increased the penalties associated with bribery in an attempt to combat corruption.

iii Tax issues

The provisions of the Tax Code[9] are frequently subject to significant revisions. Unanticipated tax matters have the potential to seriously affect the profitability of a business, and any bankability analysis conducted by lenders for the purposes of a Russian acquisition and leveraged finance transaction should take this risk into account.

The most significant tax-related event in recent years is probably the de-offshorisation initiative of the Russian authorities signed into law in November 2014 and subsequently amended in February 2016.[10] The purpose of the de-offshorisation legislation is to incentivise Russian enterprises and Russian businessmen to retain all legal entities in their group structures onshore by increasing the tax burden on group structures that feature foreign holding companies.

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6 Federal Law No. 115-FZ 'On Countering Money Laundering and the Financing of Terrorism' dated 7 August 2001, as amended.

7 Federal Law No. 273-FZ 'On Anti-Corruption Enforcement' dated 25 December 2008, as amended.

8 Criminal Code of the Russian Federation No. 63-FZ dated 13 June 1996, as amended.

9 Part I of the Tax Code of the Russian Federation No. 146-FZ dated 31 July 1998, as amended, and Part 2 of the Tax Code of the Russian Federation No. 117-FZ dated 5 August 2000, as amended.

10 Federal Law No. 376-FZ dated 24 November 2014 'On the Introduction of Amendments to Part One and Part Two of the Tax Code of the Russian Federation (Regarding the Taxation of the Profits of Controlled Foreign Companies and the Income of Foreign Organisations)' (376-FZ). Federal Law No. 32-FZ dated 15 February 2016 'On the Introduction of Amendments to Part One and Part Two of the Tax Code of the Russian Federation (Regarding the Taxation of the Profits of Controlled Foreign Companies and the Income of Foreign Organisations) and 376-FZ'.

The implications of these new rules may well result in a departure from the Russian opco, Cypriot holdco and BVI topco structures frequently used for the purposes of Russian financing transactions, and may further complicate debt pushdown structures involving foreign entities.

In Russia, the implementation of debt pushdown structures (that is, the establishment of a Russian special purpose vehicle to purchase a business with a subsequent merger or tax consolidation) is complicated. The main issue is that a Russian company cannot be merged with a foreign company. In addition, Russian thin capitalisation rules need to be considered in connection with such structures (see below).

In addition, in 2016 Russia signed up to the Common Reporting Standard (CRS) established under the relevant multilateral competent authority agreement, signed in accordance with Article 6 of the 1988 Convention on Mutual Administrative Assistance in Tax Matters (as amended).[11] The CRS will, as of 2018, enable automatic exchange of certain information between the Russian authorities and the authorities of a number of jurisdictions (including those considered 'tax havens'). The purpose of these measures is to ensure tax transparency at a global level.

Withholding tax on interest income

Russian withholding tax on interest income is currently 20 per cent. This statutory rate may be reduced in accordance with applicable double tax treaties (DTTs), provided that the lenders from the relevant DTT jurisdictions offer the borrower (acting as tax agent for the purposes of the Tax Code) their respective tax-residency certificates. Favourable DTT jurisdictions that are most frequently used in a Russian context remain Cyprus, Luxembourg and Netherlands.

iv Interest expense deductibility

Subject to certain limitations (including the arm's-length and thin capitalisation rules – see below), a Russian borrower generally has the right to deduct interest expenses on loans from operating income for the purposes of profit tax, irrespective of the purpose of the loan.

Pursuant to the recently amended arm's-length rule, the amount of interest expense deducted by a Russian borrower may not be more than the amount of interest expense calculated in accordance with the Tax Code on the basis of certain floating rates, including the CBR rates, Libor, Euribor or Shibor.

If a Russian borrower has outstanding indebtedness that qualifies as 'controlled indebtedness' for the purposes of Russian law and its ratio of debt-to-equity exceeds 3:1, then the thin capitalisation rules apply. Controlled indebtedness arises in circumstances where a Russian borrower obtains financial indebtedness from:

a its 20 per cent plus foreign shareholder;

b its Russian affiliate; or

c an independent lender, if the persons mentioned in (a) or (b) or a foreign affiliate of the borrower provide security or guarantees in respect of such loan.

11 Government Decree No. 834-p dated 30 April 2016 'On Signing of the Multilateral Competent Authority Agreement'.

In practice, (c) poses a particular problem where the lenders obtain security and guarantees from members of the target or purchaser groups. A new law signed in February 2016[12] (subject to certain conditions) exempts controlled indebtedness incurred under (c) from the thin capitalisation rules for the period starting from 1 January 2016 and ending on 31 December 2016.

As of 1 January 2017, this law will, *inter alia*:

a increase the shareholding threshold from 20 per cent to 25 per cent at which the indebtedness from the relevant shareholder or its affiliate will be considered controlled indebtedness; and

b allow indebtedness from independent banks (including foreign banks) mentioned in aforementioned bullet point (c) to be excluded from the notion of controlled indebtedness as long as a foreign affiliate has not repaid or pre-paid the relevant loan (in full or in part).

In light of the devaluation of the rouble, the rouble amount of 'controlled indebtedness' in foreign currencies can now be calculated on the basis of specific rates published by the CBR. By fixing an artificial rate, the idea is to help Russian borrowers obtain interest deductions with respect to related-party hard currency loans that otherwise would come within the thin cap restrictions due to the considerable devaluation of the rouble.

If a financing transaction falls foul of the thin capitalisation rules, the relevant interest is not tax-deductible and is also treated as a dividend for tax purposes.

III SECURITY AND GUARANTEES

i Security

A range of forms of credit support is available under Russian law. Taking effective security under Russian law has, however, been problematic historically. Reasons include the unavailability of security over certain classes of assets, and the inadequacies of the security public record and the enforcement regime. However, the changes to the security enforcement regime (as well as the amendments) have considerably improved the position and, in particular, the protection of secured creditors.

The primary security interest recognised by the Civil Code is the pledge. Under Russian law, a pledge only exists if (and for as long as) it secures a valid obligation. A pledge does not transfer legal title, even if the security asset is itself physically transferred into the possession of the pledgee. However, a pledge provides the pledgee with certain priority rights over the pledged asset and, as a result of the amendments, a pledge of shares (or participatory interests) may also confer on the pledgee the right to vote or receive dividends, or both.

Russian law distinguishes between pledges of moveable and immoveable assets (the latter type is often termed a 'mortgage' and is subject to specific rules set out in the Mortgage Law).[13]

12 Federal Law No. 25-FZ dated 15 February 2016 'Amending Article 269 of Part II of the Tax Code of the Russian Federation with respect to the notion of controlled indebtedness'.

13 Federal Law No. 102-FZ dated 16 July 1998 'On mortgage (pledge of immoveable)', as amended.

Unlike loans secured by real estate, which have benefitted from a public registration system in Russia for over two decades, security over equipment or inventory was sub-optimal prior to the introduction of the amendments. In an enforcement scenario, creditors were often unable to locate their collateral or discovered that it had also been pledged in favour of other creditors.

To address this issue, the amendments introduced a system of notification of moveable property pledges into the Civil Code, a register of such notifications and an associated voluntary registration regime. Russian notaries are the new system's gatekeepers. The pledgor or pledgee (or, in certain cases, other persons) has the right to submit a notification of pledge (either in a hard or electronic copy) to a notary for inclusion in the pledge register. This pledge register does not apply to pledges that are subject to other registration procedures, such as pledges over immoveable property or shares.

The amendments set out a new regime pursuant to which pledges may be held by multiple pledgees (either on a *pari passu* basis or at different levels of seniority). For pledges ranked at different levels, the amendments introduce a concept of 'pledge seniority'. By default, seniority is linked to the time when the relevant pledge is created (that is, when the relevant pledge agreement is entered into). However, there are important exceptions to this general rule, including that seniority may be altered by agreement among the various pledge holders. As mentioned above, these new features are likely to pave the way for further intercreditor-related developments.

Account security

Previously, only direct debit rights (which are contractual, revocable and do not create a security interest) were available to creditors; however, the amendments permit taking security over rights to bank accounts. Security can be taken over a specific type of bank account that is opened by the pledgor with the bank acting as pledgee or a third-party account bank. In the latter case, the account bank and the pledgor may not terminate or amend the bank account agreement without the consent of the pledgee. This is a major step forward in the context of receivables financings, but is also helpful in connection with acquisition and leveraged finance transactions.

Guarantees

Russian law distinguishes between 'suretyships' and 'independent guarantees'.

Under Russian law, a guarantee provided by corporate entity is referred to as a suretyship. Generally, a Russian company may provide upstream and cross-stream suretyships. Like a Russian law pledge, a suretyship only exists if (and for as long as) it secures a valid obligation. The suretyship is a quasi-security instrument, since it does not create a proprietary interest but merely gives a creditor a contractual right of recourse against the relevant entity.

An independent guarantee is another quasi-security instrument and, in essence, is similar to a suretyship. The difference between an independent guarantee and a suretyship under Russian law is that an independent guarantee creates an independent obligation of the guarantor to pay the amount stipulated in the guarantee, whereas a suretyship creates an accessory payment obligation. Prior to the amendments, independent guarantees were referred to as 'bank guarantees' and could only be provided by credit and insurance organisations.

Russian law suretyships and guarantees are both subject to certain specific rules, although, some of the more stringent rules have been significantly relaxed by the amendments, which now allow description of the relevant secured obligations by way of simple reference to the underlying loan.

Limitations on guarantees and security and corporate benefit

There is no well-developed concept of corporate benefit under Russian law. There are no specific rules regarding how security documents should be approved. Accordingly, the general rules relating to the approval of major transactions (transactions amounting to 25 per cent or more of the balance sheet) and interested-party transactions (transactions with certain related persons) apply. However, in practice, the charters of Russian companies often contain specific mechanisms for approving transactions pursuant to which security is created.

Members of the management bodies of Russian companies are generally required to act in the best interests of the company and may be held personally liable for any breach of statutory duty.

Security agents

Unlike common law legal systems, Russian law does not recognise the concept of a security agent that acts as a trustee for the lenders from time to time. Accordingly, in the context of secured financing transactions with a broad and potentially changing composition of secured creditors, a key issue is always how best to structure security in an efficient manner. Clearly, having each secured party from time to time sign a pledge agreement or register its security interest is sub-optimal for such transactions. To address this issue, various practical solutions have been developed in the market, including, most notably, a structure that includes a security agent acting as a joint and several creditor with each of the individual creditors. While these structures are likely to remain viable, they have so far not been properly tested in the Russian courts.

The amendments introduce a new structure that has the advantage of being clearly spelled out in the legislation and that is therefore likely to be welcomed by market participants, especially perhaps in the context of Russian law-governed syndicated loans.

The new structure enables the appointment by the creditors of a 'pledge manager', who conceptually is not dissimilar to a common law security agent.

Although not expressly mentioned in the amendments, it appears that a pledge manager could potentially be appointed in respect of more than one rank of secured creditors. The amendments are not clear as to how a pledge manager would simultaneously owe a duty of care to junior and senior pledgees, but nothing appears to prevent pledgees from different classes agreeing how enforcement proceeds should be distributed.

ii Insolvency issues

In cases of insolvency or insolvency proceedings against a borrower, a pledgor or a guarantor (relevant person), the following transactions entered into by such relevant person within a certain period of time prior to the commencement of the insolvency proceedings may be challenged:

a suspicious transactions: transactions without mutual consideration and on disadvantageous terms, or transactions wilfully aimed at causing harm to creditors generally; and *b* preferential transactions: transactions that lead, or may lead, to preferential treatment of a particular creditor, including transactions aimed at changing the order of priority of claims.

Pursuant to the recent amendments to the Civil Code, the arbitration manager may submit an application for invalidation on its own initiative or at the request of the creditors' meeting or committee. The amendments also allow a creditor to challenge a transaction without involving the arbitration manager if such creditor's exposure exceeds 10 per cent of the total indebtedness of all creditors featured in the ranking list. This development has the effect of simplifying the procedure for challenging antecedent transactions as interim procedures (such as creditors' meetings) are no longer necessary.

IV PRIORITY OF CLAIMS

i Priority of claims in insolvency

In cases of insolvency, the Bankruptcy Law[14] requires that each creditor assert its claims so that these are included in the ranking list, which determines the amount due by the debtor to such creditor. Most claims that arise after the commencement of insolvency proceedings have super-priority in relation to any unsecured claims and need not be included in the ranking list.

All claims that became due before the commencement of the insolvency proceedings and have been included in such ranking list are generally discharged as follows:

a first-priority claims include those arising from the debtor's liabilities to individuals for harm to life or health;

b second-priority claims arise out of the debtor's obligation to pay wages, salary or other amounts payable under employment agreements in the ordinary course of business, or to pay fees or royalties to authors of intellectual property (these claims are sub-divided into categories depending on the amount payable); and

c other claims included into the ranking list constitute third-priority claims. Claims secured by collateral over the debtor's assets are generally settled out of the proceeds from the sale of such collateral ahead of all other claims with certain exceptions. The Bankruptcy Law basically allows for allocation of 70 to 80 per cent of such proceeds to the relevant secured lenders, with the remaining 20 to 30 per cent being divided between creditors in respect of first and second priority and current claims.

Claims of creditors that are not included in the ranking list or that qualify as preferential or suspicious transactions (as described above) are generally the last creditor claims to be satisfied, and may be considered claims of fourth priority.

The Bankruptcy Law also sets out additional rules for priority of claims in the cases of bankruptcy of certain types of entities, including credit organisations (including banks), allowing for super-priority of claims of individual bank account holders and customer deposit account holders. Prior to the amendments, there was a separate law devoted to bankruptcy of credit organisations, but the relevant rules are now set out in the Bankruptcy Law.

14 Federal Law of the Russian Federation No. 127-FZ 'On Insolvency (Bankruptcy)' dated 26 October 2002, as amended.

ii Intercreditor arrangements

Prior to the amendments, the Russian legislation was silent on the ability of creditors of a non-bank debtor to enter into subordination or other ranking arrangements.

The amendments implemented the concept of 'intercreditor agreements' which aims to facilitate syndicated loans and debt restructurings in Russia. Under these new rules (substantially based on common law concept of 'intercreditor arrangements'), creditors of one borrower may conclude an intercreditor agreement so as to restrict the ability of some or all creditors (parties to such intercreditor agreement) to enforce claims or security on an individual basis set out rules on priority and subordination of claims or provide for non-proportional allocation of proceeds (or both). However, it is argued that such intercreditor arrangements do not apply to debtors undergoing bankruptcy proceedings. In such case, it is the Bankruptcy Law and not the intercreditor arrangements that will govern the procedure of satisfying creditors from these assets and determine the enforceability of the contractual ranking of claims.

Russian courts and bankruptcy administrators were previously reluctant to take into account the contractual ranking when allowing claims against the debtor's assets or when distributing proceeds to creditors. Their key argument was that the subordination is only a matter of contract between the parties to the relevant intercreditor arrangements, and that thus it does not affect the statutory rules of liquidation of the borrower's assets, which also concern third-party creditors. It is likely that such approach would be taken by the practitioners despite the fact that intercreditor arrangements are now generally allowed by the Civil Code.

Therefore, it is likely that only the statutory subordination and ranking of claims will be taken into account, with the effect that the liquidation proceeds will be distributed in the order set out above. Furthermore, the share of the bankruptcy proceeds of junior creditors will correspond to their statutory ranking of claims.

V JURISDICTION

In Russia the parties to a contract may choose foreign law as the governing law of the contract provided that the contract has a 'foreign element' (a foreign party, a foreign asset or similar). English law is most commonly chosen as the governing law of the facility agreement.

Generally, the parties are free to choose litigation or arbitration. Russian law, however, requires that certain disputes are exclusively resolved by Russian state arbitrazh (commercial) courts.[15]

In December 2015, the legislation regulating domestic and foreign arbitration was amended.[16] The majority of these amendments (the 'new arbitration rules') come into force on 1 September 2016. The new arbitration rules, *inter alia*, relate to regulation of arbitrability of certain types of disputes, overhaul the Russian arbitration court system, and limit the use of *ad hoc* proceedings. Pursuant to the new arbitration rules, most disputes relating to

15 Such disputes include insolvency disputes and certain specific 'corporate disputes' (e.g., relating to title to shares in a Russian company or encumbrances over such shares).

16 Federal Law No. 382-FZ dated 29 December 2015 'On arbitration proceedings in the Russian Federation' and Federal Law No. 409-FZ dated 29 December 2015 'Amending certain Federal Laws'.

state registration, insolvency, privatisation and public procurement are expressly considered non-arbitrable. Corporate disputes (relating to establishment and operations of legal entities and their managing bodies, and listed in the Arbitration Procedure Code)[17] may, in certain cases, be arbitrable subject to certain pre-conditions, such as institutional (and not *ad hoc*) arbitration having its seat of arbitration in Russia.

Russian courts have challenged the enforceability of dispute resolution clauses (typically found in English law finance documents) pursuant to which one party only may choose arbitration or litigation on the basis that such provisions violate the principle that each party must have equal access to justice. As a result, the parties tend to include a single dispute resolution option – usually arbitration in an internationally recognised arbitration forum such as the London Court of International Arbitration.

Foreign arbitral awards are generally recognised and enforced pursuant to the New York Convention,[18] which Russia is a party to. The judgments of foreign courts are recognised and enforced in Russia only if there is an international treaty between Russia and the country in which the judgment was issued; or a Russian federal law providing for the recognition and enforcement of court judgments from such country. However, taking into account the new arbitration rules, the parties should be careful when choosing a foreign arbitration institution with respect to certain corporate and other types of disputes.

No law or treaty currently exists that recognises and enforces judgments of the courts of England and Wales. Accordingly, arbitration is generally perceived as the only available option in respect of contracts governed by English law.

VI ACQUISITIONS OF PUBLIC COMPANIES

i Overview

Following the changes to the Civil Code and further amendments to the JSC Law[19] and LLC Law,[20] public companies in Russia are called ‘public’ joint stock companies (JSCs) (and not ‘open’ JSCs).[21]

ii Mandatory tender offers and minority squeeze-outs

Under the rules relating to mandatory tender offers (MTOs), any pledge holder who as a result of an enforcement acquires more than 30 per cent (50 per cent, 75 per cent together with its affiliates) of the voting shares in a public JSC must make an MTO to the other shareholders.

17 Federal Law No. 95-FZ ‘Arbitration Procedure Code’, as amended.

18 The Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York, 1958).

19 Federal Law No. 208-FZ dated 26 December 1995 ‘On Joint Stock Companies’, as amended.

20 Federal Law No. 14-FZ dated 8 February 1998 ‘On Limited Liability Companies’, as amended.

21 Please note that a reference to a ‘public’ JSC includes a JSC whose securities are publicly traded on a stock exchange and a JSC that may offer its shares to an unlimited number of persons.

If a pledge holder (individually or together with its affiliates) becomes the owner of more than 95 per cent of the shares in a public JSC, it must buy out the remaining shares at the request of the shareholders (MTO); or shall have the right to require that the shareholders sell their shares to it, provided that it has reached 95 per cent as a result of acquiring more than 10 per cent on the basis of a tender offer (minority squeeze-out).

In an enforcement scenario, banks tend to find third-party purchasers to bear the related MTO obligations. However, if the pledge holder itself acquires the shares and consequently reaches the 30, 50 and 75 per cent thresholds, it can avoid the MTO obligation if it sells such number of shares as is required to go below the relevant threshold no later than 35 days after such acquisition.

A bank or a third-party purchaser making a tender offer should first confirm such tender offer with the CBR (which is now the main regulation in Russian securities market). Pursuant to the recent amendments to the JSC Law, the rules on MTO and minority squeeze-out extend to non-public companies that used to be open JSCs as of 1 September 2014. Such companies may only be exempted from these rules by way of charter amendments to that effect. On 1 July 2016, certain technical amendments to the MTO entered into force. In particular, shareholders that receive an MTO should submit their request for the sale of shares to the register (depositary) rather than to the address specified in the MTO; such shares offered for sale will then be blocked upon submission of the request for sale thereof and it will become possible to effect payment for the shares acquired in the course of an MTO to the bank account of the depositary (rather than the shareholders) if the relevant shareholders are not registered in the register of shareholders.

iii Certain funds requirement

Russian legislation does not contain a certain funds requirement with regard to an acquisition of shares in a public JSC; however, the person making a tender offer must accompany it with a bank guarantee securing its obligations to pay. Such bank guarantee is irrevocable and valid for at least six months after the termination of the payment period.

iv Minority shareholders challenge

A sale or pledge of shares in a public JSC is not generally restricted under Russian law; however, if a public JSC issues new shares to an unlimited number of persons, the existing shareholders of the public JSC have a right of first refusal. If this right is disregarded, the shareholders may challenge the sale.

In addition, if a person is under an obligation to make a tender offer (including as a result of share enforcement), this may require the approval of the shareholders, in the absence of which the minority shareholders will be entitled to challenge any transactions triggered by such enforcement.

v Other permitted conditionality

The acquisition of shares in a public JSC may also trigger the requirement to obtain regulatory approvals in accordance with the Competition Law[22] or the Strategic Law.[23] From a practical point of view, a bank may not agree to provide its financing before the relevant regulatory approvals are obtained by the purchaser given that, in the absence of these approvals, the transaction may be unwound. Similar regulatory approvals may also be required in a share pledge enforcement scenario.

vi Disclosure requirements

As a matter of Russian law, a public JSC is subject to mandatory disclosure requirements. The acquisition finance is usually structured such that a purchaser is the borrower under the finance documents; and pledges shares in the public JSC upon completion of the acquisition.

Given that the public JSC is itself usually not a party to the finance documents, the terms of the financing would not typically be disclosed.

However, if the purchaser acquires control over the public JSC (on the basis of the shareholding or by way of a corporate agreement) or enters into a share pledge agreement that qualifies as a major transaction for the Russian purchaser, then such public JSC will need to disclose the terms of the pledge. When the purchaser acquires more than 5 per cent of shares in the public JSC, the latter must disclose the identity of the purchaser. If as a result of such acquisition the purchaser makes a tender offer, the terms of the tender offer will also need to be disclosed by such public JSC.

vii Confidentiality requirements

There are no specific statutory confidentiality requirements applicable to the acquisition of shares in a public JSC.

Russia has adopted the Insider Law,[24] which prohibits insider trading of information relating to a public JSC. The banks participating in acquisition finance transactions may be in possession of certain insider information relating to the acquisition and must, therefore, also comply with the Insider Law.

There is also a draft law (not yet submitted to the Duma) that aims to provide additional information access rights to minority shareholders to allow certain insider information, including information about purported acquisition financings, to be provided to them.

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22 Federal Law No. 135-FZ dated 26 July 2006 'On Protection of Competition', as amended.

23 Federal Law No. 57-FZ dated 29 April 2008 'On the Procedure of Foreign Investment in Commercial Entities of Strategic Importance for the Country's Defense and State Security', as amended.

24 Federal Law dated 27 July 2010 No. 224-FZ 'On Counteraction Against Illegal Use of Inside Information and Manipulation of the Market, and On Introduction of amendments to Certain Legislative Acts of the Russian Federation', as amended.

VIII SANCTIONS

As a result of the sanctions that have been implemented by the US and the EU in the wake of the ongoing situation in Ukraine (and the heightened vigilance of US and EU banks in this respect), foreign lenders, in addition to conducting KYC, also insist on sanctions-related provisions in the finance documents. These are frequently the subject of heavy negotiation, however, the language of these provisions has become fairly standardised.

VII OUTLOOK

2015 and first half of 2016 has proven to be an unusual and difficult period for the Russian market. However, provided that the current geopolitical tensions ease in the not-too-distant future, in the long term there is plenty to suggest that the market is generally maturing and deepening, including positive and progressive legal developments, confident local banks, established international participants and the emergence of more and more ambitious deal structures.

Chapter 19

SPAIN

Fernando Colomina and Iván Rabanillo[1]

I OVERVIEW

The Spanish economy has undergone challenging times since the economic crisis began in 2007. Since then the economy has been picking up pace, with the government implementing reforms to revive it, resulting in a recapitalisation of the banks and thereby increasing market confidence. In January 2016, Spain's Central Bank forecast economic growth of 2.7 per cent for 2016 which, when combined with the estimated 3.2 per cent for 2015, represents a significant increase on previous years.[2]

The recapitalised environment led to post-2007 highs of loan and high-yield leveraged financings in 2014, primarily for debt refinancing purposes. This trend tailed off in 2015 with the absolute number of leveraged financings decreasing from 11 in 2014 to just six in 2015. Likewise, the principal amount of debt decreased eightfold to €1.495 billion in 2015 down from a high of €13.42 billion in 2014.[3]

Interestingly, according to the same source, in 2015 high-yield bond issuances (made up of nine deals with a combined principal amount of €4.050 billion) accounted for 73 per cent of the total debt raised, with only the remaining 27 per cent being raised through leveraged loans, giving the impression that debt financing patterns are returning to those of 2013, where to a degree high-yield bonds seemed to be replacing leveraged loans for Spanish financings.[4]

These figures are, however, somewhat misleading as there is little difference in the number of high-yield bond loans in 2014 and 2015, with the value of issuance in 2014 being

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2 www.bde.es/f/webbde/GAP/Secciones/SalaPrensa/NotasInformativas/Briefing_notes/es/notabe010416.pdf.

3 Source: 'A brave new world for international leveraged debt', published by Debtwire in association with White & Case.

4 Ibid.

€4 billion issued across 14 deals, compared with €4.05 billion issued across nine deals in 2015.[5] This points to the conclusion that it was not a rise in high-yield issuances that took place in 2015 but a fall in loan volumes. This was largely driven by alternative methods of financing, a heightened regulatory environment and a decrease in the number of acquisitions by PE firms. Likewise, the leveraged finance market was hit by the retreat of construction, house building and healthcare companies, all of which had a particularly strong year in 2014. It is to be noted, however, that this fall in the number and value of leveraged loans is a European trend and is not unique to the Spanish economy.

As for use of proceeds, these were split between refinancing (at 28 per cent), leveraged buyout (LBO) financing (at 38 per cent) and add-on acquisitions (at 34 per cent). This represents a significant change from 2014, where use of proceeds was dominated by refinancing (78 per cent) with only 8 per cent of proceeds being used to fund LBOs.[6] This change can largely be seen as a natural consequence of the decrease in leveraged financings but is also exaggerated by the strong comparison period in 2014, when issuances were at a post-2007 high.

So far the picture for 2016 remains largely unclear, although the first quarter of 2016 has shown a 50 per cent reduction in the number of leveraged loan issuances when compared with the first quarter of 2015 with the value of such issuances dropping by 36 per cent[7] and there have been no high-yield issuances to report so far this year. Undoubtedly, this is a reflection of the political uncertainty and unease in the markets surrounding both the Spanish national elections and changes within the European Union. It remains to be seen how these will affect both the leveraged loan and high-yield spaces going forward, but it is hoped that deal activity will pick up when greater certainty merges.

As for the type of financial advisers, according to MergerMarket,[8] the top 15 advisers by value and by deal count remain mainly non-Spanish traditional banks and advisers, such as Goldman Sachs, JPMorgan, HSBC and Morgan Stanley as well as the 'Big Four' accountancy firms. Compared with 2014, a few names have either emerged on the scene or climbed to the top including BNP Paribas, ING, ANZ Bank and N+1. As for the Spanish players, only Banco Bilbao Vizcaya Argentaria and Santander appeared in the top 15 in 2015.

II REGULATORY AND TAX MATTERS

i General regulatory requirements

Generally speaking, no regulatory permits or authorisations are required to act as a lender or a security agent in finance deals in Spain, although certain regulatory authorisations and registrations are required to act as a credit entity for the general public (in simplified terms, to raise reimbursable deposits from the public). That said, lenders and borrowers that are resident in Spain have general ongoing formal obligations to inform the Bank of Spain about any new transactions, as well as the status of existing transactions, with non-Spanish borrowers and lenders (as applicable).

5 Ibid.
6 Ibid.
7 Source: Debtwire Analytics: European Leveraged Finance – 1Q16 Primary Issuance.
8 MergerMarket: Trend Report H1 2016 Financial Advisers League Tables.

ii Sanctions and anti-money laundering

Sanctions

As a member of the European Union and United Nations (UN), Spain follows the sanctions imposed by the Security Council of the UN and by the EU authorities under the Common Foreign and Security Policy. Therefore, the identity of all the parties involved would normally be checked prior to starting a financing.

AML regulations

Anti money-laundering (AML) regulations in Spain require that, prior to initiating any business relationship, the ultimate beneficial owner (UBO) of the parties involved in the deal must be clearly identified.

For legal entities, the UBO is defined, in simplified terms, as the natural person who ultimately owns or controls, directly or indirectly, more than 25 per cent of the share capital or voting rights of the legal person, or who by other means controls, directly or indirectly, the management of a legal person.

In the event that a particular legal entity has no UBO (as defined above), the personal details of its directors should be disclosed. In the event that a director is a legal person, the personal details of its representatives (or directors) should be disclosed.

These requirements are of particular significance in Spain because, while notarisation of a loan document is not required by law, notarisation affords the lenders material enforcement advantages; as such, it is market practice to do so. In addition, as a general rule Spanish security interests must be notarised; in any case, it is again market practice to do so. A notary will refuse to grant the relevant deed or materially qualify it if there is any failure to satisfy these UBO requirements.

iii Tax matters

Deductibility of interest

Spanish corporate income tax (CIT) law does not provide for a thin capitalisation regime, but has an interest-stripping regime limiting the deductibility of net interest expenses to 30 per cent of adjusted operating profits (roughly speaking, earnings before interest, taxes, depreciation and amortisation (EBITDA)) in a given fiscal year, with a €1 million floor. The excess difference could benefit from a carryover for an indefinite period of time. Where a taxpayer incurs net interest expenses not exceeding this €1 million floor, the difference between such interest cost and the floor amount will increase the applicable 'cap room' in the five subsequent years. These rules must be tested at a group level where the Spanish borrower belongs to a Spanish fiscal unity (subject to the 'anti-LBO' rules described below).

The existence of a Spanish fiscal unity could have certain advantages. In general, a leveraged holding company may be able to shelter taxable income obtained by its subsidiaries belonging to the Spanish fiscal unity against interest expenses incurred at the holding company level. Furthermore, dividends received by such a holding company from its qualifying subsidiaries not belonging to the fiscal unity[9] (to the extent they benefit from the Spanish participation exemption regime)[10] would be treated as additional EBITDA for purposes of the interest-stripping regime.

It should be noted that the Spanish interest-stripping rules are generally in line with the conclusions of Action 4 of the Base Erosion and Profit Shifting (BEPS) initiative[11] and with the contents of the proposed EU Anti-tax Avoidance Directive approved by the ECOFIN in June 2016. At this stage, no significant amendments to the Spanish rules outlined above have yet been announced, but many foreseeable changes that may take place in order to reflect the Directive's contents do not appear to be detrimental to taxpayers.[12]

On the other hand, there are certain anti-abuse rules that may limit the availability of interest deductions within a fiscal unity or upon a post-acquisition merger. For instance, an 'anti-LBO' rule imposes an additional limitation to the deductibility of interest accruing on debt incurred to make acquisitions of shares.[13] Under this rule, where the bidco vehicle and the target company merge or form a fiscal unity in the four years following the acquisition, the above-mentioned 30 per cent EBITDA limitation should be tested taking into account only bidco's standalone EBITDA and not the fiscal unity's (or the EBITDA corresponding to the merged entity, as the case may be). To the extent that bidco is a special-purpose vehicle set up for purposes of performing the shares acquisition (and not an operating entity), this rule would, in practice, prevent that acquisition interest was tax-deductible.

In order to dispel allegations that the anti-LBO rule put private equity firms at a disadvantage as regards industrial groups, the Spanish lawmaker introduced an 'escape clause' to the 'anti-LBO' rule, whereby the additional 30 per cent limitation would not apply if: (1) the level of leverage does not exceed 70 per cent of the purchase price of the shares acquired; and (2) such acquisition debt is reduced on a proportionate basis within the eight years following the acquisition, until the debt reaches a threshold of 30 per cent of the purchase price.[14] Where the acquisition is financed through different kinds of loan facilities (e.g., junior,

9 For instance, non-Spanish resident subsidiaries, or Spanish-resident subsidiaries that do not meet the requirements to belong to a fiscal unity (in general, a 75 per cent participation in the share capital – 70 per cent if the subsidiary is a listed company – and majority of the voting rights).

10 Roughly speaking, the exemption applies where a Spanish parent company holds a direct or indirect stake of at least 5 per cent (or having an acquisition cost of at least €20 million) in a Spanish or foreign subsidiary, held for a minimum one-year holding period. Foreign subsidiaries must also meet a 'subject-to-tax' test. Certain limitations apply where, for example, the subsidiary is a holding company or where it is deemed to be an 'asset-holding' company.

11 Sponsored by the OECD and sanctioned by the G20.

12 For example, an increase of the minimum interest deductibility floor up to €3 million, the introduction of safe harbours to infrastructure-financing projects and the introduction of a consolidated group ratio rule

13 This rule is not applicable in respect of target companies that have been integrated in the fiscal unity of the relevant bidco in a fiscal year starting prior to 20 June 2014.

14 The Spanish tax authorities, in binding tax ruling V1664-15, dated 28 May 2015, have addressed certain queries made by a private equity firms association regarding the practical applicability of the anti-LBO rule. As per the tax authorities, the fulfilment of the second requirement should be tested on an annual basis, by comparing the level of indebtedness

senior, mezzanine, vendor loans or other types of loans), the amortisation required under the anti-LBO rule may be performed in any of such facilities, provided that the combined outstanding principal amount of all of them does not exceed the maximum threshold for the year in question.[15] On the other hand, the indebtedness existing at the target company prior to its acquisition does not appear to fall under the scope of such rule.

In addition, there are other anti-abuse rules under Spanish tax law that may limit the deductibility of interest incurred by a Spanish borrower. Interest expenses arising in connection with intragroup debt, where that debt is used to acquire shareholdings from other group entities or to perform equity contributions into other group entities are non-deductible, unless the borrower is able to evidence to the Spanish tax authorities that there are sound business reasons for the transactions[16] Furthermore, interest accruing on profit-participating loans (PPLs) granted by group entities (provided that the PPLs have been granted after 20 June 2014),[17] and interest accruing on hybrid instruments if the interest is not taxed or taxed at a rate lower than 10 per cent at the level of the grantor, are also non-deductible. Spanish transfer-pricing rules may also be used by the Spanish tax authorities to challenge interest deductibility in a related-party loan and to reclassify debt instruments into equity instruments.

Withholding tax

General rules

From a practical perspective, it is standard for foreign lenders to use EU-based vehicles to make loans to Spanish borrowers, as it is not market practice for borrowers to gross-up interest

of the bidco at the end of each fiscal year with the acquisition debt. Even if the acquisition debt accounted for less than 70 per cent of the purchase price, its principal amount should be nevertheless reduced proportionally on annual basis over such eight-year period until it reaches 30 per cent. Nonetheless, if in a given year the acquisition debt is reduced at an amount exceeding the minimum amount required to be amortised as per the amortisation schedule of the anti-LBO rule, the taxpayer may not be required to reduce it further in subsequent years until the remainder of the debt catches up with the amortisation schedule.

15 See binding tax ruling V1664-15. It should be noted that the failure to meet the mandatory amortisation requirements in a given fiscal year does not jeopardise the taxpayer's ability to deduct interest on the debt in future fiscal years, provided that the taxpayer catches up with the amortisation schedule in such subsequent years.

16 In that regard, it should be noted that there are good grounds to defend (as per the criterion set forth by the Spanish tax authorities in certain binding tax rulings – such as V0775-15, dated 10 March 2015), that there are 'sound business reasons' where the leveraged intragroup acquisition is performed in a connection with a post-acquisition debt push-down plan (e.g., following the acquisition of a multinational group, partly financed with bank debt, the purchaser group sets up a structure that would allow a portion of such acquisition debt to be allocated to Spain), provided that the portion of the debt pushed down to Spain is reasonable. In any event, it is generally advisable that a taxpayer seeks a binding tax ruling from the Spanish tax authorities in order to implement such a restructuring plan.

17 A grandfathering rule ensures that interest accruing on PPLs granted prior to such date remain tax-deductible (subject, however, to the other rules limiting the deductibility of interest described herein).

withholding tax (WHT) levied on payments made to lenders who are not 'qualifying lenders' (i.e., lenders entitled to an interest withholding exemption). As a general rule, payments of Spanish-sourced interest are currently subject to WHT at a 19 per cent rate. Tax haven-based lenders will be subject to this standard WHT rate. EU-based lenders (or EU permanent establishments of EU-based lenders)[18] may receive interest free from Spanish WHT, subject to the fulfilment of compliance requirements (e.g., holding a valid government-issued tax residence certificate). Spanish-resident registered banks and registered Spanish permanent establishments of foreign banks also benefit from the WHT interest exemption. Finally, certain tax treaties entered into by Spain may also provide for a WHT exemption on interest (e.g., the Spanish–Swiss tax treaty and the Spanish–US tax treaty (once the new protocol to the Spanish–US tax treaty, which was signed in 2013 and is still pending approval by the US Senate, enters into force)), also subject to the fulfilment of compliance and specific eligibility requirements.

Anti-abuse

Spanish tax law does not provide for a definition of 'beneficial owner' in respect of interest. In fact, the above-mentioned rule exempting interest payments made to EU lenders from WHT does not provide for a 'beneficial ownership' provision. Notwithstanding this, the Spanish tax authorities may, based on general anti-abuse principles, challenge back-to-back lending structures where the lender of record in relation to the Spanish borrower (generally an EU lender claiming the WHT exemption) channels the funds to an ultimate lender. Sub-participation arrangements may be particularly troublesome from a Spanish borrower's perspective, as payments made thereunder may be regarded as interest from a Spanish tax perspective[19] and might give rise to the same anti-abuse concerns. An assessment of the robustness of a lending structure against such potential challenges must be carried out on a case-by-case basis. Special attention must be paid to the features of the loan instruments involved, the substance of the lending entity and its level of capitalisation.

Special regime for notes offerings

Spanish tax law provides for a special tax regime[20] applicable to, *inter alia*, qualifying notes offerings made by Spanish resident companies and by wholly owned subsidiaries of Spanish

18 Except for EU-based lenders resident in or obtaining interest through a permanent establishment located in Spain or in a tax-haven jurisdiction. Currently, no EU Member States are deemed to be tax havens from a Spanish tax perspective, but a recent tax reform allows the Spanish tax authorities to revisit the tax haven blacklist depending on certain factors (e.g., where there is no effective exchange of tax information, or where the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes Identifies a jurisdiction as a tax haven).

19 In that regard, the reasoning applied by the Spanish tax authorities in binding tax ruling (V0593-15, dated 16 February 2015), which analyses a crowd-lending scheme with certain features similar to a sub-participation, may indicate that the Spanish tax authorities could favour such interpretation.

20 Act 10/2014, dated 26 June, on the organisation, supervision and solvency of credit entities.

companies resident within the EU,[21] provided that certain additional requirements relating to the offering (e.g., the listing of the notes on a suitable exchange) are met, and certain compliance information is timely supplied by the paying agent involved. This regime provides for a WHT interest exemption on payments made to all foreign noteholders, regardless of their jurisdiction of residence (i.e., tax-haven investors are not penalised) and without requiring individualised tax documentation (such as government-issued tax-residence certificates) to be supplied.

Horizontal tax groups

As a reaction to recent European Court of Justice (ECJ) decisions,[22] several EU countries – including Spain – have amended and extended their tax consolidation regimes in order to prevent challenges to their own rules before the ECJ.

As from fiscal years starting from 1 January 2015, the new Spanish Corporate Income Tax Act (the CIT Act) has enlarged the scope of the tax consolidation regime, and allowed that:

> *A Spanish parent company (or permanent establishment) holding a direct or indirect participation in a Spanish subsidiary through intermediate holding companies resident in any country other than Spain could form a tax group including such indirect Spanish subsidiaries, provided that the indirect shareholding of such Spanish parent company represents (1) at least 75 per cent of the share capital of the Spanish subsidiary (70 per cent if the subsidiary has its stock listed in a regulated stock exchange); and (2) the majority of the subsidiary's voting rights.*

Spanish subsidiaries of a common non-Spanish resident parent company[23] form a horizontal tax group that would include all Spanish-resident direct or indirect subsidiaries in respect of which such non-Spanish parent company had a shareholding meeting the requirements described above (i.e., 75 per cent of share capital, and majority of the subsidiary's voting rights).

The Spanish Congress went beyond the rulings of the ECJ (which would have required that such measures applied in respect of investment from or through EU or EEA entities), and extended the applicability of the tax consolidation regime to holdings held out of any jurisdiction. The wording of the law (and in particular, the rules governing the formation

21 It should be noted that notes offerings carried out by non-Spanish issuer vehicles, where the offering proceeds are ultimately used in Spain, should be carefully reviewed, in light of the criterion set forth in the recent binding tax ruling V4139-15, dated 28 December 2015, where the Spanish tax authorities took the view that interest accrued under such notes could be deemed to be from Spanish sources for Spanish WHT purposes. In such cases, it would be crucial to ensure that the offering meets the criteria to be a qualifying notes offering from a Spanish tax perspective, and that the applicable compliance obligations are duly met by the paying agent involved.

22 Cases C-40/13, and joint Cases C-39/13 and 41/13, where the ECJ ruled that the Dutch fiscal unity regime rules had breached EU law because, *inter alia*, the rules did not allow a fiscal unity between two Dutch 'sister' companies held by a common parent company based in the EU/European Economic Area (EEA).

23 Except for parent companies that are resident in a tax-haven jurisdiction.

of horizontal tax groups) creates several pitfalls that may affect a wide array of industries (e.g., multinational groups with Spanish investments, private equity sponsors, and financial institutions financing Spanish acquisitions).

For instance, under the new horizontal group rules, a multinational group's parent company holding indirect investments in different businesses without any relationship whatsoever among them from an organisation standpoint (which is a fairly common situation in multinational conglomerates) could be deemed to be the parent company of a sole fiscal unity that should be automatically formed by all the Spanish entities it owns. Under the Spanish CIT Act provisions (which have already been interpreted by the Spanish tax authorities),[24] if these indirect Spanish subsidiaries already formed their own tax groups in Spain, one of the pre-existing tax groups should cease to exist, with the degrouping charges that could derive from such a termination (i.e., recapture of certain intragroup gains that were eliminated in the past owing to the applicability of the consolidated tax regime). Spanish law does, however, not determine which tax group should be terminated.[25] The integration of both pre-existing groups into a single tax group should be effective as from fiscal year 2016.[26]

Another example of unwarranted implications of the new horizontal group rules may be followed in private equity structures. Generally, private equity sponsors have 'master' holding companies in an EU jurisdiction, and make leveraged buyout acquisitions through Spanish bidco vehicles partly financed through loans granted by financial institutions. Once the Spanish bidco acquires the shares of the Spanish 'target' company, bidco and target generally form a tax consolidated group. In such structures, the second Spanish investment made indirectly from the same master holding company (with the same bidco–target structure) may turn out not to be eligible to form a standalone tax consolidated group. The fact that there is a common parent company for both the first bidco and the second bidco would mean that the entities related to the second acquisition (i.e., the second bidco and the second target group) should form a single horizontal tax group.

Such an unwarranted outcome may be a great inconvenience for the private equity sponsor (as the financial models prepared for the first acquisition – prepared taking into account the features of the first target and the first bidco's leverage level – may be significantly

24 Temporary provision 25, subsection 2. This provision has been interpreted by the Spanish tax authorities in binding tax ruling V2037-15 (dated 30 June 2015). The case described in the mentioned ruling was the case of two Spanish consolidated tax groups that had a common parent company resident in Luxembourg. As per the Spanish tax authorities, as from fiscal year 2015 both groups should be combined into a single tax group (as the qualifying parent company of both groups was the same Luxembourg entity).

25 See binding tax ruling V2037-15. This means the taxpayer may choose to terminate the pre-existing group that could trigger fewer degrouping costs.

26 Temporary provision 25, subsection 5 of the Spanish CIT Act.

changed)[27] and for the financial institutions (as the formation of a horizontal tax group may imply an additional exposure to tax risks associated with companies that did not fall under the perimeter of the acquisition that was financed).[28]

While there may be strategies to structure investments in order to avoid the adverse implications of such new regime,[29] their implementation requires individualised tax advice.

III SECURITY AND GUARANTEES

i Parallel debt

Parallel debt structures governed by Spanish law are not used in the Spanish market, as there would be a high risk of their being declared null and void pursuant to the Civil Code owing to the absence of a legal reason supporting the debt. Therefore, a security agent under a syndicated finance deal will not be able to hold any debt or security on behalf of the lenders acting as agents pursuant to a parallel-debt structure. Accordingly, the relevant security interest must be granted in favour of each and every secured party.

From a practical point of view, it is important to bear in mind that all lenders must be party to the relevant security documents by means of duly authorised representatives holding sufficient powers of attorney (which must be notarised and apostilled, or otherwise legalised, as the case may be, for lenders incorporated outside Spain) in order to be deemed secured parties under those security documents. Where the nature of the financing requires a security agent to be party to the security documents on behalf of the lenders, the lenders must grant a special power of attorney (also notarised and apostilled or legalised for lenders incorporated outside Spain) for the security agent to act on their behalf. In this event, the security agent would not act as an agent, but rather as an authorised signatory of the lenders.

ii Financial assistance

When structuring acquisition finance deals or refinancing previous acquisition finance deals, it is important to bear in mind that neither Spanish limited liability companies (SRLs) nor *sociedades anónimas* (SAs, which are the most common form of Spanish corporations, as they limit the liability of the relevant shareholders) may secure or

27 Several Spanish CIT rules require the fulfilment of requirements at the tax group level (for instance, the rules limiting the deductibility of interest), and the enlargement of a tax group may lead to unexpected tax inefficiencies (and to a greater tax compliance burden).

28 Entities belonging to a tax group are jointly and severally liable for the CIT debts of the group. In addition, the inclusion of entities in a tax group means that such entities may have accounts payable and receivable as regards other group entities, depending on whether an entity benefits from tax credits or attributes of another entity of the tax group. This aspect may also be troublesome from the perspective of the financial institutions involved.

29 For instance, the Spanish tax authorities have interpreted that certain investment structures with features designed to ensure that a 'master' holding company could not meet the requirements set out under the Spanish CIT Act to be regarded as a parent entity that could have the status of a head of a consolidated tax group (see e.g., the recent binding tax rulings V1813-16, dated 25 April 2016, and V1083-16, dated 17 March 2016). However, the use of such structures should be approached with caution, and on a case-by-case basis.

guarantee, or participate, help or render any sort of assistance for the acquisition of their own shares or quotas, or those of their parent companies. Further, Spanish SRLs may not secure or guarantee, or participate, help or render any sort of assistance for the purchase of the shares or quotas of any company within their group. Any security or guarantee created that constitutes unlawful financial assistance in accordance with the foregoing rules is null and void. Additionally, financial assistance may raise civil liability issues for the directors and, potentially, may be criminal offences.

The typical structure to avoid financial assistance was traditionally the 'forward merger'. However, in 2009, the Structural Modifications Act[30] introduced an exception to the general merger rules when the relevant merger implied financial assistance. By means of this law, in the case of a merger between two or more companies where any of them has incurred debt in the three years prior to the merger in order to acquire control of any of the other companies involved in the merger or to acquire assets of any of the other companies involved in the merger that are essential for normal operation or are significant for the equity value of said company, certain special rules apply, including that an independent expert appointed by the relevant mercantile registry must render an opinion on whether the financial assistance exists. This generates uncertainty, and generally the forward merger leveraged buyout structure is no longer used, having been replaced with different debt pushdown mechanisms chosen on the basis of the accounting situation of the target company.[31]

By means of the above rules set forth in the Structural Modifications Act, the Spanish legislator (based on the former English whitewash procedure) has attempted to find a way for leveraged mergers not to result in financial assistance. Nevertheless, as previously stated, instead of clarifying doubts and filing gaps, this new piece of legislation has created even more doubts, and the effectiveness of this rule in limiting undercapitalisations seems doubtful.

iii Limitations on security and guarantee

The corporate benefit concept is not expressly recognised under the Spanish legal system. Nonetheless, several points should be borne in mind:

a if a Spanish company grants security or guarantees where the transaction pursuant to which the security granted is not found to result in the ultimate corporate benefit of said company, the directors of that company could be in breach of their fiduciary duties;

30 Act 3/2009 of 3 April on structural modifications of capital companies.

31 In addition, the performance of a post-LBO forward merger requires analysis from a Spanish tax perspective, as it is key that such merger can be performed in a tax-neutral fashion (which requires, *inter alia*, that the reorganisation is deemed to have been performed due to sound business reasons and not for tax-driven ones). Such mergers have been contested by the Spanish tax authorities in the past (especially in structures where the merger could give rise to certain tax advantages, such as the recording of amortisable goodwill), and it is market practice that such mergers are performed only to the extent a favourable advanced tax ruling is obtained from the Spanish tax authorities.

b to the extent that the power to grant security or a guarantee for the benefit of third parties is not included in the directors' powers, the directors may need to seek a special authorisation from the company's shareholders; and

c under the Insolvency Act,[32] any agreement entered into by a Spanish company within the two-year period immediately preceding the company's declaration of insolvency may be rescinded by the relevant insolvency court, provided that the insolvency receiver deems that the terms of the agreement are detrimental to the insolvent estate.

There is a presumption in the Insolvency Act that provides that, if they are detrimental to the insolvent estate, the following will be declared null and void: any guarantees that secure a third party's debt and that provide no direct or indirect benefit for the grantor; and any mortgages and pledges granted to secure an existing obligation.

However, any security or guarantees granted as part of a refinancing transaction pursuant to Article 71-bis and additional provision 4 of the Insolvency Act are not subject to these general clawback risks.

In view of the above, corporate guarantees may only be granted to the extent that they result in the granting company's corporate benefit, and that said benefit is deemed by the relevant court to effectively exist. Insolvency courts do not always take a 'group' approach when looking into corporate benefit matters; rather, they tend to assess the corporate benefit in relation to the interests of the insolvent company alone. As such, it cannot be completely ruled out that all guarantees that secure third-party debts and that do not have a direct consideration could be declared null and void.

These considerations are particularly relevant when considering upstream guarantees. Insolvency courts have consistently deemed that upstream guarantees or security are gratuitous transactions since there can be no benefit for the guarantor. Downstream guarantees, on the other hand, may be justified by the interest of a parent company to preserve its investment in its subsidiary.

In a non-insolvency situation, the corporate benefit requirement still applies. However, it does not need to be quantified, and it will not prevent a guarantee from covering working capital facilities that are not linked to the acquisition of the company's or its holding company's shares or quotas.

It is worth noting that Spanish SRLs must obtain their shareholders' approval prior to issuing upstream guarantees.

iv Security

The most typical securities in the Spanish market are real estate mortgages and pledges over shares or quotas,[33] bank accounts and credit rights. Promissory mortgages are also not unheard of in the Spanish market.

It should be noted that a universal floating catchall security, similar to an English law debenture or US Uniform Commercial Code security interest, are not recognised under

32 Act 22/2 03 of 9 July on insolvency.

33 The share capital of SRLs is composed of 'quotas', whereas the share capital of SAs is composed of 'shares'. This distinction is especially important with regards to the application of RDL 5/2005 (see below).

Spanish law. In contrast, each security interest over each asset class is documented in a separate deed and signed before a notary public. In this sense, Spanish law security documents must accurately describe the assets that are subject to a particular charge.

Mortgages

As a general rule, pursuant to the principle of speciality, each mortgaged asset may secure the obligations arising from one debt instrument only. However, when all lenders are financial entities (as defined in Article 2 of the Spanish Mortgage Market Act)[34] and certain formal requirements are also met, the relevant mortgage may be created in the form of a maximum liability mortgage, which may secure obligations arising from several debt instruments up to the said maximum liability (the global real estate mortgages).[35]

Spanish law mortgages can be created over real estate assets and over moveable assets such as intellectual property rights, industrial machinery, aircraft, vehicles and business premises; as a perfection requirement, they must all be registered with the relevant public registry.

The mortgage deed must expressly mention the maximum amount of the underlying obligations that is secured by the mortgage. In this sense, it is important to carry out a cost-benefit analysis, given that stamp duty must be paid on the basis of the maximum secured amount. Currently, the stamp duty applicable to public deeds of mortgage may generally range between 0.5 and 2 per cent of the secured amount.

It should be noted that assignments between lenders of commitments under the relevant facility agreement do not automatically result in the assignment of the assigning lender's participation in the mortgage. The assignment of the mortgage must be expressly documented and registered with the relevant public registry in order for the acquiring lender to become a mortgagee of record. Further, stamp duty is levied on the basis of the commitment being transferred.

The mortgage deed must include the Spanish tax identification numbers of all of the parties to enable the Spanish authorities to identify each party thereto. It should be noted that acquiring a tax identification number in Spain does not entail *per se* any tax obligations or mean that the relevant entity has a permanent establishment in Spain: this will depend on the facts and circumstances regarding a foreign person's actions and business in the Spanish territory.

Finally, although the Spanish regulations set forth that mortgages may be enforced through court or by out-of-court (i.e., notarial) proceedings, recent case law suggests that out-of-court enforcement may not always be available, particularly in the event that the mortgagor is a consumer and the mortgaged asset is the mortgagor's home.

Pledges

Spanish law does not expressly regulate the possibility of creating a single global pledge to secure several obligations. However, both global real estate mortgages[36] and global guarantees

34 Act 2/1981 of 25 March, on the regulation of the mortgage market.

35 Article 153-bis of Spanish Mortgage Law dated 8 February 1946.

36 See Section III.iv, 'Mortgages', *supra*.

are expressly recognised under Spanish law.[37] In this sense, based on the acceptance of the application by analogy of the mentioned regulations, it is a widespread market practice to grant a single global pledge to secure several obligations, which is generally considered acceptable in Spanish academic literature.

There are two main types of pledges under Spanish law: pledges with transfer of possession and pledges without transfer of possession.

Pledges with transfer of possession

Pledges with transfer of possession require the possession of the pledged asset to be transferred to the creditor or to a third party for the purposes of perfecting the pledge. For assets that are not physically transferable, there are presumptions that certain actions (e.g., granting the pledge as a Spanish deed, delivering notices) are equivalent to transferring possession of the relevant asset.

Under certain circumstances, pledges with transfer of possession may be subject to RDL 5/2005,[38] which incorporated the European Financial Collateral Directive[39] into Spanish law and aims to facilitate enforcement of financial collateral arrangements.

To benefit from this regime, the following requirements, *inter alia*, must be met:

a at least one of the parties to the arrangement must be a financial institution, as defined in Directive 2006/48 of the European Parliament and of the Council of 14 June 2006 relating to the taking-up and pursuit of credit institutions;

b the pledged asset must be cash (i.e., the money credited to an account in any currency); marketable securities[40] and other financial instruments; or specific receivables (i.e., those money claims arising out of an agreement whereby a credit institution grants credit in the form of a loan agreement or a credit line); and

c the financial collateral arrangement must have been formalised in writing.

The main advantages of RDL 5/2005 for lenders are as follows:

a no formalities (e.g., registration, notices, transfer of possession) are required other than documenting the arrangement in writing;

b it allows for the direct sale or appropriation of the pledged asset; and

c it provides certain protections against insolvency, given that the initiation of insolvency proceedings is not considered sufficient grounds to declare null or to rescind a financial collateral arrangement.

Finally, to the extent that the pledged asset is located in Catalonia, the Catalonian Civil Code[41] applies. In this case, it should be noted, *inter alia*, that second and subsequent

37 Article 98 of Spanish Royal Decree Law 3/2011 of 14 November, which approves the Consolidated Text of the Public Sector Contracts Act.

38 Royal Decree Law 5/2005 of 11 March on urgent reforms for boosting productivity and to improve public procurement.

39 Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.

40 Quotas in a SRL do not qualify for these purposes.

41 Act 5/2006, of 10 May, of the fifth book of the Civil Code of Catalonia, regarding *in rem* rights.

pledges are expressly prohibited (unless they are created for the benefit of the same creditors and the secured obligations are split among them); and that the maximum amount secured by the pledge must be clearly stated in the deed of pledge (in a similar way as previously mentioned for mortgages).

Significantly, this type of security does not attract stamp duty.

Pledges without transfer of possession

Pledges without transfer of possession do not require the possession of the pledged asset to be delivered. However, they must be registered in the relevant moveable assets registry as a perfection requirement.

Unlike mortgages, provided the pledge is granted as a Spanish commercial deed and not as a notarial deed, no stamp duty will be levied. However, the deed of pledge must still include a reference to the maximum amount of secured obligations that is secured by the pledge without transfer of possession. Spanish tax identification numbers are required to have the pledge registered.

As regards assignments between lenders, similarly to mortgages, the assignment of a lender's position under a pledge without transfer of possession must be expressly documented and registered with the relevant public registry.[42]

Similarly to pledges with transfer of possession, to the extent that the pledged asset is located in Catalonia, the Catalonian Civil Code[43] applies. In this event, it should be noted, *inter alia*, that it is unclear whether a pledge may secure the obligations arising from more than one debt instrument.

As a result of certain legal interpretations arising from some unclear amendments to Article 90.1.6 of the Spanish Insolvency Law, it was usual during a short period of time to structure pledges over credit rights as pledges without transfer of possession. On 1 October 2015, however, the Spanish parliament passed the Public Sector Legal Regime Act, which amended Article 90.1.6 of the Spanish Insolvency Law, removing any doubt as to the validity of pledges over credit rights, whether present or future (arising from agreements entered into before the declaration of insolvency), if those pledges are structured by means of an ordinary pledge with a transfer of possession, following the Spanish Civil Code. Therefore, currently there is no material benefit from granting non-possessory credit rights pledges instead of traditional credit rights pledges and, hence, market participants are structuring pledges over credit rights as pledges with transfer of possession in order to avoid registration requirements.

Promissory mortgage

Promissory mortgages are not unusual in Spanish finance deals. A promissory mortgage does not create an *in rem* right of mortgage, but rather creates an obligation for the grantor in relation to the relevant lenders party thereto to create an *in rem* right of mortgage upon the agreed trigger event.

42 See Section III.ii, *supra*.

43 Act 5/2006, of 10 May, of the fifth book of the Civil Code of Catalonia, regarding *in rem* rights.

Promissory mortgages are typically used when the amount of stamp duty that would be levied on the relevant mortgage deed is too large compared with the risk of default or, generally, with the benefit of creating a mortgage upon closing a deal.

In any case, lenders should bear in mind that the conversion of the promissory mortgage into a legal mortgage requires the payment of the stamp duty that was initially avoided, and that it entails significant insolvency limitations and a high rescission risk.

Irrevocable powers of attorney

It is usual in the Spanish market to have the mortgagor or pledgor grant a special power of attorney in favour of the security agent (or even the lenders) to carry out certain actions on its behalf. Pursuant to such irrevocable power of attorney, the security agent is typically authorised to carry out perfection, further assurance and enforcement actions on behalf of the relevant mortgagor or pledgor with respect to the relevant security documents.

To ensure that the mortgagor or pledgor may not unilaterally revoke the power of attorney, the security agent is usually party to the deed of power of attorney, and certain specific language is included.

Finally, it is worth mentioning that the scope of the powers granted in favour of the security agent or lenders should be carefully defined in order to avoid their potential classification as shadow directors in an insolvency proceeding of the grantor.

IV PRIORITY OF CLAIMS

i Types of claims

Once insolvency has been declared, the court receiver draws up a list of acknowledged claims and classifies them according to the following categories.

Claims against the insolvency estate

These claims are payable when due according to their own terms (and, therefore, are paid before all other claims under insolvency proceedings; see below). Claims against the insolvency estate include the following:

- *a* a certain amount of the employee payroll;
- *b* the costs and expenses of the insolvency proceedings;
- *c* certain amounts arising from services provided by the insolvent debtor under reciprocal contracts and outstanding obligations that remain in force after insolvency proceedings are declared, and certain amounts deriving from obligations to return and indemnify in cases of voluntary termination or breach by the insolvent debtor;
- *d* amounts deriving from the exercise of a clawback action during the insolvency proceedings regarding certain acts performed by the insolvent debtor and corresponding to a refund of consideration received by it (except in cases of bad faith);
- *e* certain amounts arising from obligations created by virtue of law or from tort after the declaration of insolvency and until its conclusion;

f 50 per cent[44] of the funds lent under a refinancing arrangement entered into in compliance with the requirements set forth in Article 71-bis (refinancing agreements) or additional provision 4 (homologation of refinancing agreements) of the Spanish Insolvency Act; and

g certain debts incurred by the debtor following the declaration of insolvency.

Insolvency claims

Insolvency claims are subject to the insolvency proceedings and, unlike the claims against the insolvency estate, are paid in accordance with the waterfall set forth in the Spanish Insolvency Act. Insolvency claims, in turn, are classified as follows:

a claims benefiting from special privileges, representing basically security on certain assets (essentially *in rem* security, to the extent secured by *in rem* security);

b claims benefiting from general privileges include certain labour debts and certain debts with public administrations corresponding to tax debts and social security obligations (which are recognised as generally privileged for half of their amount), and debts held by the creditor applying for the corresponding insolvency proceedings (to the extent such application has been approved) up to 50 per cent of the amount of such debt. Funds under a refinancing arrangement entered into in compliance with the requirements set forth in Article 71-bis of the Spanish Insolvency Act in the amount not admitted as a debt against the insolvency estate will benefit from general privileges;

c ordinary claims (unsubordinated and non-privileged claims); and

d subordinated claims, which are classified contractually or by virtue of law). Debts subordinated by virtue of law include, *inter alia*, claims that have been notified late by the creditors, fines, claims related to accrued and unpaid interest unless and to the extent they are secured by an *in rem* right, as well as, in particular, credit rights held by parties that are specially related to the debtor (discussed further in Section IV.ii, *infra*).

In the event of liquidation of the insolvent company, claims are paid in accordance with the above waterfall (i.e., claims against the insolvency estate first, specially privileged claims (to the extent secured) second, generally privileged claims third, ordinary claims fourth and subordinated claims last). In the event that there is more than one creditor within a particular class, claims are paid on a *pro rata* basis.

ii Subordination

Credit rights may be subordinated by virtue of law, by contractual agreement or as a result of the structure of the debt.

44 However, until 2 October 2016, 100 per cent of the new funds under a formal refinancing will be regarded as a claim against the insolvency estate; and from 2 October 2016, the regime will apply again (i.e., 50 per cent of the new money in a refinancing will be regarded as a claim against the insolvency estate and the remaining 50 per cent will be regarded as a generally privileged claim).

Pursuant to the Insolvency Act, credit rights held by parties that are specially related to the debtor are subordinated. In the case of individuals, this includes their relatives. In the case of legal entities, this includes:

a shareholders, group companies and their common shareholders, provided that:
- they are personally liable for the debtor's debts;
- they owned directly or indirectly over 5 per cent (for companies that have issued securities listed on an official secondary market) of the entity's share capital when the relevant debt was incurred; or
- they owned directly or indirectly over 10 per cent (for companies that have not issued securities listed on an official secondary market) of the entity's share capital when the relevant debt was incurred; and

b directors and *de facto* (shadow) directors, liquidators and attorneys holding general powers of attorney, as well as those who held such positions within the two years immediately preceding the initiation of insolvency proceedings.

In addition to the above, there is a presumption that any persons who have acquired credit rights from the specially related persons described above within the two years immediately preceding the initiation of insolvency proceedings are also specially related to the debtor. Therefore, such claims will become subordinated.

Notwithstanding the above, it is noteworthy that creditors who have capitalised all or part of their claims pursuant to a specially protected refinancing agreement under Article 71-bis or additional provision 4 of the Insolvency Act are not deemed specially related persons as a result of said refinancing; and any creditors who enter into a specially protected refinancing agreement under Article 71-bis or additional provision 4 of the Insolvency Act are deemed not to be *de facto* directors due to the obligations assumed by the debtor pursuant to said refinancing agreement (although evidence to the contrary may be admitted).

As regards first-lien and second-lien structures, the part of the first-lien facility that remains unsecured after enforcement of the relevant security will rank *pari passu* with the second-lien facility. In this sense, lenders would have to rely on the provisions of the relevant intercreditor agreement for effective subordination of the second-lien lenders. It should be noted that the subordination provisions of intercreditor agreements have not yet been tested in Spain, although they should work among relevant creditors pursuant to Article 1255 of the Civil Code.

V JURISDICTION

Choosing the laws of any jurisdiction other than Spain will generally be given effect by the Spanish courts subject to, *inter alia*, the terms of the Rome I Regulation[45] and in accordance with the exceptions and provisions of the laws of Spain, provided that the relevant applicable law is evidenced to the Spanish courts pursuant to Article 281 of the Spanish Civil Procedure Act.[46]

45 Regulation (EC) No. 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I).

46 Act 1/2000 of 7 January on Civil Procedure.

Further, a final judgment obtained against any debtor or guarantor in a country other than Spain (and other than a country bound by the provisions of EU Regulation No. 1215/2012)[47] would be recognised and enforced by the courts of Spain, unless such judgment contravenes principles of Spanish public policy, pursuant to the following rules:

a the judgment is in accordance with the provisions of an applicable treaty;

b in the absence of any such treaty, if it can be alleged and evidenced that the jurisdiction in which the foreign judgment was rendered recognises Spanish judgments on a reciprocal basis (positive reciprocity) when the requirements established in such foreign jurisdiction for the recognition of Spanish judgments are complied with and provided that certain minimum conditions are met (Spanish exclusive jurisdiction for certain matters, public policy and absence of contradiction with a previous Spanish judgment); and

c in the absence of any such treaty and where reciprocity has not been evidenced (and, according to certain court precedents, even if positive reciprocity has been evidenced), the judgment would be enforced in Spain if it satisfies all of the conditions set forth in the former Spanish Civil Procedure Act of 1881 (which the case law identifies with the minimal conditions referred to above and include the regularity of the proceeding followed by the foreign court and the authenticity of the judgment) required by the Spanish Civil Procedure Act.[48]

VI ACQUISITIONS OF PUBLIC COMPANIES

Loans in the context of Spanish public-to-private (P2P) transactions are not that different from non-P2P acquisition finance deals, although lenders need to focus on the bank guarantees that the Spanish Securities Market National Commission requires as evidence that the relevant acquirer will be able to comply with its obligations under the public offer to purchase, to make sure that these are adequately integrated in the financial documents and to consider the unconditional nature of these guarantees at the time issued. These requirements obviously vary on a case-by-case basis.

VII OUTLOOK

Although raising new funds remains difficult, the Spanish market is slowly but surely picking up pace.

Given the regulatory requirements that still remain in place for Spanish banks and the credit restrictions they entail, it can be anticipated that borrowers will continue to look to alternative, more creative and perhaps even aggressive ways of financing their corporate

47 Regulation (EU) No. 1215/2012 of the European Parliament and of the Council on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters.

48 For further information, see Article 954 of the former Spanish Civil Procedure Act of 1881, which is still applicable pursuant to the abrogation provision included in the Spanish Civil Procedure Act.

needs. Further, it would make sense for borrowers to look for more flexible and cost-efficient structures, and it can be expected that alternative financing providers will gain further entry into the market.

In view of the above, it is likely that more borrower-friendly structures, such as unitranche facilities, high-yield bonds and covenant-lite deals, will become commonplace in the medium to long term. In addition, alternative and more flexible financing providers (such as collateralised loan obligations) are likely to become strong players in the market.

Market players will also be considering the impact of further anticipated amendments to the Spanish Insolvency Act, which are expected, *inter alia*, to facilitate the reorganisation and survival of viable companies with financial difficulties.

Chapter 20

SWEDEN

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I OVERVIEW

Bank financing is still the most common source of acquisition finance on the Swedish market. The Swedish leveraged finance market in general has long been virtually dominated by bank finance (often with additional mezzanine financing on top). The big Nordic banks are still the biggest lenders, even though European banks are showing renewed interest following the recovery after the banking crisis. However, during the past 10 years, the market has seen an increase in corporate bonds (high-yield and investment-grade) as well as other alternatives to bank financing, such as shadow lenders, alternative debt providers and financing by preference shares.

The Swedish corporate bond market has, at the same time as it has grown, become increasingly harmonised. For instance, independent agent functions have been established, although the automatic right for the agent to represent the bond holders before court has not been confirmed in any court cases. In 2013, the Swedish Securities Dealers Association published for the first time a draft of harmonised terms and conditions for high yield corporate bonds. The draft terms and conditions are free for everyone to use, and have found general acceptance on the Swedish market as a starting point for mechanical non-commercial terms and conditions for Swedish corporate bonds.

II REGULATORY AND TAX MATTERS

i Regulatory matters

Banking and financing services provided in Sweden are regulated by, *inter alia*, the Banking and Financing Business Act.[2] European banks can passport the licence they have in their

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2 2004:297.

home country into Sweden and either open a Swedish branch or register for cross-border services. However, a foreign lender does not need a licence or to be incorporated locally solely to lend to Swedish entities or to obtain security over assets located in Sweden, including acting as a security agent on behalf of other lenders.

Listed corporate bonds are subject to listing requirements (however, it is not a legal requirement to list the bonds) of the Swedish Financial Supervisory Authority and the regulated market where they are listed (if applicable), for example, the rulebook for issuers from Nasdaq Stockholm as applicable on its regulated market, and, *inter alia*, requirements regarding the prospectus for listing and rules regarding market abuse and disclosure obligations.

Since Sweden is a Member State of the EU, banks, investment firms and funds are subject to a growing number of regulations and among the most obvious newer regulations are the CRD IV Directive[3] and the CRR Regulation.[4] As has been the case for other European banks, this has led to increased efforts among domestic banks to keep up with the compliance work required by such rules and regulations both from a legal and a financial or structural perspective. This may increase the competitiveness (at least to some extent) and business opportunities for less regulated sources of funding, such as alternative debt providers.

ii Tax

In connection with leveraged financing in general, profit repatriation and servicing of debt by the target group are arguably the two central tax considerations together with the rules concerning tax consolidation. These must be analysed in detail in each specific case.

Profit repatriation and servicing of debt may be done through dividend distributions. A dividend from a Swedish subsidiary is tax exempt to the extent covered by the participation exemption. These rules exempt gains made on a sale of 'business-related shares' from Swedish capital gains tax (a corresponding loss is not deductible), and a dividend on such a shareholding would not be taxable. Dividends from foreign jurisdictions are generally tax-exempt, provided that the subsidiary is the equivalent of a Swedish limited liability company and covered by the participation exemption rules. This is a key concern to analyse with local counsel in other jurisdictions when structuring an acquisition.

Profit repatriation and servicing of debt may also be done through interest payments on intragroup loans. Interest payments received constitute taxable income. Interest payments made by Swedish companies are tax deductible provided the interest level is set at arm's-length and the debt is not contrary to the interest deduction limitation rules, which are discussed in more detail below.

Swedish tax consolidation

The Swedish tax consolidation system provides for group contributions between group companies as a way of consolidating for tax purpose. The criteria are, *inter alia*, that ownership exceeds 90 per cent of the share capital at each step of the procedure. The group contributions

3 Directive 2013/36/EU of the European Parliament and the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms.

4 Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms.

are taxable in the receiving company and tax deductible in the paying company, meaning that profits can be shifted to a loss-making company in the same group and offset against the tax losses. Group contributions require sufficient distributable reserves in the providing company since group contributions are considered to be dividends for company law purposes. In profitable companies with no negative equity, this should not be a problem as long as the amount contributed does not exceed annual profits. However, group contributions are only possible between companies that have been in the same group for the entire financial year, or (much simplified) since the subsidiary began conducting business of any kind.

Withholding tax

There are no withholding taxes on interest payments or domestic dividend distributions under Swedish law, but a dividend distribution to a non-Swedish company does, in principle, trigger a 30 per cent withholding tax. In practice, however, such withholding is usually avoided as a result of applicable exemptions under domestic law in which (much simplified) the receiving entity is comparable with a Swedish limited liability company or it is a beneficiary under a comprehensive tax treaty. Furthermore, holding requirements may apply. The domestic rules are more generous than the minimum requirements under the Parent-Subsidiary Directive.[5]

Deductibility of interest

There are no formal debt-to-equity (thin capitalisation) rules or earning-stripping rules in Sweden for tax purposes, and interest accrued on third-party loans (e.g., bank loans or corporate bonds) is generally tax-deductible. The use of shareholder loans and the debt-to-equity ratio may thus provide scope for flexibility as regards cash repatriation through interest deductions. However, Swedish company law stipulates that a company must enter into compulsory liquidation proceedings if, at any time, the total equity falls below 50 per cent of the registered share capital. Hence, it is recommended that the registered share capital be limited in relation to share premiums or free equity reserves. Interest paid between related parties must be at arm's length in order to be deductible and deductions in excess of the arm's-length rate will be rejected. Provided the interest on intercompany loans is properly benchmarked and documented in accordance with transfer pricing documentation rules (and not profit related), interest costs will generally be deductible.

Furthermore, as of 1 January 2013, Sweden has interest deduction limitation rules that cover all loans between affiliated companies, and interest on such loans will only be tax-deductible if:[6]

a the beneficial owner of the interest is subject to taxation at a rate of at least 10 per cent, and the loan was not predominantly put in place for tax reasons; or

b the beneficial owner of the interest is resident in the European Economic Area ((EEA), comprising the members of the EU and (currently) Iceland, Liechtenstein and Norway) and the loan was predominantly put in place for business reasons.

5 Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

6 Similar rules were introduced already in 2009, but since they were limited in scope they did not have the intended effect. Consequently, the rules were broadened in 2013.

The new interest deduction limitation rules apply to all loans from affiliated companies, regardless of the purpose of the loan. The rules since 2013 have been heavily criticised and are currently being reviewed by the Ministry of Finance. Further, on 21 June 2016, EU Member States agreed to move forward with the Anti Tax Avoidance Directive (ATAD), including a minimum requirement for rules to limit interest deductions.[7] Much simplified, the proposed rules limit the interest deduction to 30 per cent of EBITDA or €3 million. Any new Swedish rules introduced need to comply with the ATAD, but since there is still broad scope for local variation it is still too early to comment further on what the Swedish rules will ultimately look like.

III SECURITY AND GUARANTEES

Leveraged finance transactions are normally backed by a comprehensive security and guarantee package where material group companies provide guarantees as principal obligor as for their own debt in respect of the borrower's and the other guarantors' obligations. As discussed below, financial assistance rules exist that limit the possibilities for Swedish target companies to guarantee and provide security for acquisition debt. Therefore, the guarantees and security provided by the target group would at least initially only cover facilities to refinance existing indebtedness and facilities for general corporate purposes or add-on acquisitions.

i Security packages

Acquisition financing is commonly secured by (at least) a pledge of shares in the acquiring entity, the target company and other material companies in the target group. The material group companies are also typically guarantors, and provide security together with other group companies needed to fulfil certain guarantor coverage tests. Corporate bonds on the Swedish market are either secured or unsecured. Even fully secured bonds usually do not benefit from a security package as extensive as that for traditional bank financing, and may in this sense be considered a more flexible source of funding.

As mentioned above, two of the most common types of collateral (assets) are shares (security over which is created by pledge, i.e., delivery of share certificates executed in blank and notification to the company) and intragroup loans, which are contractual rights (if structured as a non-bearer instrument, perfected by notification to the relevant debtor). The reason shares and intragroup loans are seen as 'market standard' to provide as collateral is because security can be granted and perfected immediately on closing, and because they are not associated with any stamp duty or further measures such as registrations with Swedish authorities. Depending on the nature of the business of the borrower group, further types of security may also be provided.

Further examples of security and collateral in Sweden are listed below (this list is not exhaustive):

a real property: a real property mortgage creates a priority in specific real property up to the amount of the mortgage certificate. Any existing mortgage certificates held by a guarantor are typically part of the security package in a leveraged financing, but the issue of new mortgage certificates is often avoided as it entails stamp duty;

7 The ATAD has only been published in draft form at the time this article was published, please refer to public EU sources for the final version.

b moveable property in general: a business mortgage is a kind of floating charge that creates a priority up to the amount of the business mortgage certificate in substantially all moveable property (subject to certain limitations) of the mortgagor from time to time. Any existing business mortgage certificates held by a guarantor are typically part of the security package in a leveraged financing, but the issue of new mortgage certificates is often avoided as it entails stamp duty;

c bank accounts: it is possible to pledge bank accounts, but, for the pledge to be perfected (i.e., to be enforceable against third parties such as other creditors), the pledgor cannot dispose over the account or the balance of the account, so the account needs to be blocked. Therefore, it is often of limited value to pledge bank accounts in Sweden;

d invoices, trade receivables and contractual rights: like bank accounts, the security arrangements must exclude the pledgor from collecting or disposing of the receivable, which makes security over receivables tricky to obtain other than for long-term receivables;

e intellectual property rights: patent and trademarks can be pledged by registration in the relevant public registers;

f pledges over ships and aircraft and mortgages on ships and aircraft; and

g other types of security, rights of retention, etc.

In addition to the above, security can arise, rather than be created, in certain situations; for example, when a party has assets in its possession, that party may hold on to such assets pending payment of an outstanding debt.

Second-ranking security is also possible. In cases of enforcement, the first-ranking pledgee can enforce the pledge and apply the monies received against the debt owed. The second ranking pledgee can only receive any surplus once the first ranking debt is paid. Where senior lenders and mezzanine lenders or bond holders or other creditors have entered into an intercreditor agreement, however, it is more common for a security agent to represent all lenders and to follow the order of priority set out in the intercreditor agreement rather than for the mezzanine lenders or other lower-ranking lenders to take a second or third-ranking pledge.

At the moment, chattels are transferred or pledged according to the principle of *traditio* (with the exception for certain registration). Much simplified, chattels have to come into the possession of the new owner or pledgee to be effective against third parties. However, in 2015 a committee initiated by the Swedish government published a report with a proposal for new laws aiming to change this for chattels.[8] If new laws came into force as proposed in the report, chattels would be transferred by contract and pledged by registration (and certain publication requirements). It is uncertain if the report will lead to such new laws, but if so, it may have some effects.

ii Limitations on security and guarantees

There are limitations on the granting of security and guarantees by a Swedish limited liability company. The limitations relate to what is generally referred to as the general loan

8 SOU 2015:18.

prohibition, financial assistance and value transfers, respectively, discussed further below. Different provisions apply for regulated entities, state entities, foundations and other legal entities or private persons.

General loan prohibition

Under Swedish law, a limited liability company may not grant loans, or provide security or guarantees, to a natural person or legal entity who is a shareholder, director or managing director (including spouses and close relatives) in the company or in another company within the group, or to legal entities controlled by any such person (general loan prohibition). There are exceptions to the general loan prohibition, two of the most common being as follows:

a when the debtor is an entity within the same group as the company granting the loan or security. This exception is arguably the most common exception, and is applicable when the parent entity is a Swedish or foreign legal entity domiciled within the EEA; and

b a company may grant loans, security or guarantees, or a combination thereof, if the loan, security or guarantee, or a combination thereof, is intended exclusively for the borrower's business operations and the company provides the loan, security or guarantees, or a combination thereof, for purely commercial reasons.

Financial assistance prohibition

A Swedish limited liability company may not grant loans, security or guarantees, or both, for the purpose of a purchaser (hereinafter acquiring entity) acquiring its shares or shares in its direct or indirect parent company (financial assistance prohibition).

The rationale behind the provision is to prevent an acquiring entity without sufficient funds or that is unable to obtain external financing on its own merits from acquiring the company by using the assets of the company to pay (or secure) the payment of the purchase price. The financial assistance prohibition is only applicable if the loan, security or guarantee, or a combination thereof, is made or resolved prior to, or in connection with, the acquisition. In practice, this means that in transactions where the financial assistance prohibition may be applicable, the target companies do not grant security and guarantees (nor do they undertake to do so) until a certain time post-closing, and such guarantees and security are subject to limitation language except in the acquiring entity and its parent companies.

Strictly, the financial assistance prohibition only applies when the acquisition involves shares in the company, or a company above the company with a direct or indirect Swedish parent company. Hence, if the shares of any other foreign parent company are acquired, the financial assistance prohibition will not strictly apply, but this must be assessed on a case-by-case basis.

Value transfers and corporate benefit

A Swedish limited liability company may not make dividends in excess of its distributable funds (as set out in the latest adopted annual financial statement) less the amount needed to prudently cover the company's restricted equity taking into account the needs of its business and that of its subsidiaries (if any) (the so-called prudency rule).

If a Swedish limited liability company guarantees or grants security for another entity's debt and such guarantee or security are not in the corporate (commercial) interest of the company (or if such guarantees or security are in excess of what is in the company's corporate interest), the transaction constitutes a value transfer comparable with a dividend. Thus, when a company is providing a guarantee or a security for a third party's obligation, whether the company gains any benefit from the transaction must be taken into consideration. The issue of corporate benefit is a business decision, and is ultimately a question for the board of directors of the company to determine before entering into a transaction. If the transaction is deemed a value transfer, it is subject to the limitations concerning dividends and requires the consent of shareholders. A value transfer is therefore unlawful if it exceeds the amount of the distributable funds after considering the prudency rule.

iii Concerns regarding security before commencement of insolvency proceedings

There are two types of insolvency proceedings in Sweden: bankruptcy and company restructuring. In both proceedings, recovery actions can be taken to claw back certain transactions carried out prior to the start of the insolvency proceedings if such actions have been detrimental to the interest of other creditors. Please note that the below only highlights the most commonly used clawback grounds used to challenge or invalidate security.

Security provided by a Swedish entity during a three-month 'hardening' period (calculated backwards from the date on which the entity applied for bankruptcy or company restructuring) is vulnerable to clawback unless it was provided (and perfected) when the debt was created or was transferred without delay after the creation of the debt.

Furthermore, if a lender could be deemed to be a closely related party to a debtor (and pledgor), the hardening period is significantly increased. In relation to security provided after the creation of a debt, as per the example above, and if the security was transferred to a person or legal entity who is a closely related party to the debtor, the recovery period is up to two years before the debtor filed for bankruptcy and may be subject to clawback unless it is shown that the debtor neither was, nor by the action became, insolvent.

Security or other rights of a lender may also be affected by improper actions. Improper actions include, a situation where a creditor has been favoured at the expense of other creditors, assets of the debtor have been transferred beyond the control of the creditors or the debts of the debtor have increased to the detriment of the creditors. The recovery period in the event of improper actions is five years, provided that the debtor was insolvent when the transaction was executed, or became insolvent as a result of the transaction itself or in conjunction with other actions and the counterparty was aware or should have been aware of that and the basis for the action being improper. A closely related party is deemed to be aware of the above unless it can show on a balance of probabilities that it was neither aware nor should have been aware. There is no limit on the recovery period on actions or transfers in relation to closely related parties.

IV PRIORITY OF CLAIMS

i Legal order of priority

The priority of claims and order of payment in a Swedish bankruptcy are stipulated in the Swedish Rights of Priority Act[9] and the Swedish Bankruptcy Act,[10] the main principles of which are as follows:

9 1970:979.

10 1987:672.

a claims against the bankruptcy estate (such as fees or costs of the bankruptcy administrator, and also costs accrued by the estate during the bankruptcy proceeding (e.g., VAT claims or claims from third parties due to agreements that they have entered into with the bankruptcy administrator));

b claims with specific priority (e.g., pledges over shares in subsidiaries, trademarks, patents and thereafter business mortgages and real property mortgages);

c claims with general priority (e.g., certain employees' claims for wages and other compensation, certain accounting costs);

d claims without priority (which normally rank equal in priority (*pari passu*) and will be satisfied proportionally); and

e subordinated claims.

The concept of equitable subordination does not exist as such in Sweden, but a lender's relation to the debtor can have other implications, in particular in relation to clawback periods (as briefly described above) for security and guarantees.

ii Intercreditor agreements and structure

Structural subordination of mezzanine lenders or bond holders as opposed to senior lenders has been quite common in the Swedish leveraged finance market, but it has never been the only method used. Senior lenders sometimes agree not to have structural seniority but rely instead on intercreditor agreements or subordination agreements to ensure their priority. It is unclear, however, to what extent a bankruptcy administrator would abide by the intercreditor agreement when making payments from the bankruptcy estate. The first-priority creditor may therefore need to rely on the turnover provisions rather than the general priority in cases of bankruptcy of the debtor.

The use of often simplified Loan Market Association-based intercreditor agreements is widespread in the Swedish leveraged finance market, but there are certain national peculiarities that may be noted.

As mentioned above, it is not certain that a Swedish administrator dealing with a bankruptcy or company restructuring in the debtor company would follow the intercreditor agreement rather than applying the legal priority. In this case, the first priority lenders may need to rely on the turnover provisions of the intercreditor agreement.

Release of intragroup debt or shareholder debt in an enforcement scenario has never been tried by a Swedish court. For this reason, lenders with a share pledge commonly also request a pledge over any material shareholder or intragroup loans going into the pledged entity, so that they will be able to sell the loans and the shares to the same buyer.

Under Swedish law, there is no equivalent to the common law concept of a trust; consequently, there are no provisions under Swedish law that deal specifically with the function of a foreign law trustee. The common assumption, however, is that a trustee would most likely be considered an agent or otherwise an entity with a power of attorney to act on behalf of the lenders.

Under Swedish law, to avoid any potential grounds to challenge the perfection of the security, a pledgor should not be allowed to dispose freely of a pledged asset and the pledgee should not be obliged to release security at the simple request of the pledgor (subject to certain limitations). It is therefore often stipulated that Swedish security is not automatically released in connection with permitted disposals, for example, but rather is subject to the security agent's active release, and the security agent should retain a certain discretion as to whether such release is given.

V JURISDICTION

Generally, Swedish courts will recognise and apply a foreign choice of law clause unless, for example, it would be contrary to Swedish public policy or mandatory rules of Swedish law to do so. However, if security is to be provided over assets situated in Sweden, our recommendation would be to have the security perfected in accordance with Swedish law in addition to such chosen foreign law because, under Swedish international private law rules, Swedish law would be applicable to *in rem* rights. Swedish courts may recognise the validity of a security interest created under a non-Swedish law security document, assuming it is valid under the law of the security documents, but the enforceability in Sweden is nevertheless subject to the requirement that necessary actions were taken under Swedish law to create the relevant form of security.

The parties can submit to the jurisdiction of an arbitration institute or a foreign court. However, if an agreement is governed by Swedish law, it would not be advisable to choose a foreign court or a foreign arbitration institute as such institutions may not be accustomed to applying Swedish law. Further, it is not certain that a Swedish court would consider itself to be the appropriate forum at the request of the lenders, for example, if another forum has been agreed but the right has been reserved for the lenders to also bring proceedings before the courts in any country where the obligors may have assets.

A judgment obtained in the courts of any EU Member State or in Norway, Switzerland or Iceland would be recognised and enforceable in Sweden provided that certain actions are taken (e.g., the foreign judgment needs to be referred to the Svea Court of Appeal in Stockholm). Sweden is also a party to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958. A judgment obtained in the courts of any other foreign jurisdiction would as a starting point not be enforceable in Sweden; however, such judgment could be used as evidence in a Swedish court.

VI ACQUISITIONS OF PUBLIC COMPANIES

The main body of rules relating to takeover offers regarding companies with their shares or depositary receipts admitted to trading on a regulated market in Sweden is the Act on Public Takeovers,[11] which is based on the EC Takeover Directive,[12] and the takeover rules of the Nasdaq Stockholm.[13] In addition to these takeover rules, the Swedish Companies Act, Swedish securities legislation (e.g., with respect to disclosure requirements of substantial

11 2006:451.

12 Directive 2004/25/EC of the European Parliament and the Council of 21 April 2004 on takeover bids.

13 The Nordic Growth Market (NGM) has identical rules for its main market. For companies with their shares or depositary receipts listed on the multi-trading facilities First North, Nordic MTF and AktieTorget, similar rules apply.

holdings, insider dealing and reporting requirements to the Financial Supervisory Authority) and statements by the Swedish Securities Council perform an accessory role in regulating takeover matters.

As regards financing of take-private acquisitions, the Swedish takeover rules stipulate that a takeover bid may only be made after preparations have been made to demonstrate that the offeror is capable of implementing the offer. This includes a form of certain funds requirement, and the offeror must ensure that sufficient financial resources are available throughout the offer period.

Several disclosure requirements in connection with a take-private offer concern the financing, and the offeror must disclose, for example:

a the main terms of the offer, including the price, any premium and the basis for calculating such premium;
b how the offer is financed (in detail, although not the fees);
c conditions for withdrawal of the offer; and
d subscription or underwriting commitments received in respect of a cash issue necessary for completion of the offer.

There are also confidentiality and insider restrictions to consider, as a takeover offer always (up and until it has been made public) constitutes insider information and, for example, a syndication of the loan would then be subject to confidentiality since it could be insider information.

An offer may be made subject to conditions that entitle the offeror to withdraw the offer. The conditions must be described in detail and must be objective (i.e., they must not depend solely on the subjective judgement of the offeror, or the fulfilment of such conditions is in its hands). An offeror may make the offer conditional on a lender disbursing the acquisition loan. A condition to completion of this nature gives the offeror an opportunity not to complete the offer in the event of breach by the lender of a facility agreement (e.g., due to insolvency or refusal to permit drawdown). Conditions for drawdown of the loan under a facility agreement, however, may not be invoked generally as grounds for not completing the offer. To be invoked, such conditions must be set out as specific conditions for completion of the offer (and thereby must comply with the requirement for, for example, objectivity) and not in the loan agreement. As a result, reliance on the conditions will be subject to an assessment of materiality by the Securities Council. The conditions on a lender paying the loan shall be stated in the press release (and the offer document).

A shareholder in a listed company may pledge its shares. It may also be noted that certain disclosure requirements may arise in the event that a pledgee must enforce its security, and if it acquires the shares itself and becomes a shareholder. The disclosure thresholds are 5, 10, 15, 20, 25, 30, 50, 66⅔ and 90 per cent of the shares or votes. The 90 per cent threshold (of the shares) is also the threshold for invoking minority squeeze-out. The takeover rules also contain rules on mandatory offers, and the requirement to make a mandatory offer is triggered when a party (or parties acting in concert) acquires shares and thereby reaches or exceeds a threshold of 30 per cent of the votes in a target company. However, it is unlikely in practice that these rules would ever pose a risk that a pledgee would be compelled to make an offer on the entire company, because the rules would not apply unless the pledgee, rather than a third party, would have acquired the shares from a share enforcement.

VII OUTLOOK

As noted in Section I, *supra*, the Swedish market has long been dominated by bank financing as the main means of acquisition and leveraged financing, and domestic banks have dominated the market. Although alternative means of financing, such as corporate bonds and alternative debt providers, have grown considerably, during the past decade bank financing has remained the primary source of acquisition and leveraged financing.

The banking sector remains subject to regulatory developments, primarily as a consequence of increased regulatory efforts within the EU. It is expected that this will continue in the future both on the EU level and as regards national legal development.

Chapter 21

SWITZERLAND

Lukas Wyss and Maurus Winzap[1]

I OVERVIEW

In 2015 and in the first half of 2016, the Swiss market for acquisition and leveraged finance was still very much influenced by the low interest rate environment. The Swiss National Bank (SNB) still applies negative interest rates on larger sight deposit account balances of -0.75 per cent. The interest rates in the Swiss franc market continue to be at historically low levels – in mid-May 2015, the three-month CHF Libor was as low as -0.80 per cent. While there was some recovery, yields of Swiss government bonds are now at very low levels again (10-year bonds at about -0.50 per cent).

As a consequence, the lack of investment opportunities at attractive yields has had a significant influence on investor appetite, also in the acquisition and leveraged finance space, and leverage ratios have been further pushed.

Transactions seen in the Swiss market during the past 12 months included leveraged buyouts of large private and public Swiss targets, as well as a substantial number of smaller buyouts. Also in Switzerland, Chinese investors have been active and involved in a number of larger transactions, such as the public takeover of Syngenta, the public takeover of gategroup and the takeover of SR Technics.

Large Swiss acquisition finance transactions are usually arranged through the London or US market and are placed with banks and institutional investors. Like in many other jurisdictions, these structures included either the placement of acquisition term-loan tranches with institutional investors (rather than banks), the issuance of high-yield notes, or both.

In some transactions, bridge financing was provided to facilitate the acquisition process and the closing mechanics, and taken and refinanced by the high-yield notes financing as soon as possible after closing.

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Debt packages for large leveraged acquisition finance transactions varied, *inter alia*, depending on the volume and leverage required. The transactions consisted of either senior debt only; or senior debt and one or several layers of junior debt.

In most cases, the debt package was completed by a (revolving) working capital facility lent at the target level and structured as super-senior debt. The super-senior level derives from the structural preference and is usually also reflected in intercreditor arrangements.

Smaller Swiss domestic acquisition finance transactions, on the other hand, are often financed by Swiss banks, including Swiss cantonal banks and smaller financial institutions. These financings are usually held by the banks on their balance sheet until full repayment of the financing. In those types of transactions, the decision to lend is often supported by cross-selling opportunities. However, non-bank lenders have become more and more competitive, as they may offer more flexibility in terms of pricing.

II REGULATORY AND TAX MATTERS

i Regulatory matters

The mere provision of acquisition finance does not itself trigger a licensing requirement under Swiss laws. A licensing requirement would only be triggered if lenders would refinance themselves by means of accepting money from the public or via a number of unrelated banks. Lending into Switzerland on a strict cross-border basis is currently not subject to licensing and supervision by the Swiss Financial Market Supervisory Authority FINMA.

ii Tax matters

The tax structuring of acquisition finance transactions is more challenging, in particular due to the Swiss Non-Bank Rules.[2]

10/20 Non-Bank Rules

When structuring a syndicated finance transaction involving Swiss borrowers to comply with the Non-Bank Rules, the usual approach is to limit the number of non-banks (investors) to

2 The Swiss Non-Bank Rules comprise two rules: the Swiss 10 Non-Bank Rule and the Swiss 20 Non-Bank Rule. The Swiss 10 Non-Bank Rule defines, *inter alia*, the circumstances in which a borrowing by a Swiss borrower or issuer will qualify as 'collective fundraising' (similar to a bond). If the borrowing qualifies as collective fundraising, interest payments on the borrowing will be subject to Swiss withholding tax at 35 per cent.

Under these Rules, withholding tax will be triggered when either a lending syndicate consists of more than 10 non-bank lenders (Swiss 10 Non-Bank Rule) or a Swiss obligor has, on aggregate (that is, not in relation to a specific transaction only), more than 20 non-bank creditors (Swiss 20 Non-Bank Rule).

For the purposes of the Swiss Non-Bank Rules, a financial institution qualifies as a bank (whether the financial institution is Swiss or non-Swiss) if it is licensed as a bank and it performs genuine banking activities with infrastructure and own personnel.

A breach of the Swiss Non-Bank Rules may result in the application of Swiss withholding taxes. Such taxes would have to be withheld by the Swiss obligor and may (depending on any applicable double taxation treaty) be recoverable in full or partially by a lender.

10. This approach is obviously not feasible in larger leveraged acquisition finance transactions, where term-loan tranches or notes are placed outside of the banking market. Accordingly, funds under these transactions may not be raised by a Swiss borrower or issuer, but rather through a top-tier acquisition vehicle incorporated abroad in a jurisdiction that has a beneficial double tax treaty with Switzerland (for the purposes of up-streaming dividends without withholding any amounts). Given the generally beneficial double tax treaty between Switzerland and Luxembourg, typical structures often involve multi-level acquisition vehicles incorporated in Luxembourg.

If funds raised by a non-Swiss borrower are lent on within the group to a Swiss target company, this may be regarded as a circumvention by the Swiss Federal Tax Administration (SFTA). This is especially relevant if the Swiss target company guarantees and secures the acquisition financing. However, the SFTA has previously considered and approved structures that have included these structural elements by way of binding tax rulings. Nevertheless, the process must be carefully structured, with due consideration of the time needed for the tax rulings.

If the transaction includes a (revolving) working capital facility lent directly to the (Swiss) target companies, compliance with the Swiss Non-Bank Rules can only be achieved by limiting the number of non-banks to 10. To ensure the acquisition debt portion of the financing (which typically has more than 10 non-banks as lenders or noteholders) does not affect the working capital facility, it is key to structure these facilities in order for them to qualify as separate financings for the purposes of the Swiss Non-Bank Rules. Against this background, loss sharing provisions and similar (equalisation) provisions contained in intercreditor arrangements must also be carefully structured or confirmed by the SFTA (by way of a tax ruling) against the Swiss Non-Bank Rules.

Deductibility of interest expense

Under Swiss tax law, interest incurred at the level of the acquisition vehicle is not available for set-off against income generated at the Swiss target company level for income tax purposes. This is because there is generally no tax consolidation under Swiss tax law (neither in Swiss domestic nor cross-border situations). However, there are means to (indirectly) 'push down' the acquisition debt portion, particularly if the existing debt can be refinanced at the target level. For the purposes of the Swiss Non-Bank Rules, this would need to be structured as a downstream loan from the acquisition vehicle to the target level (or by refinancing the existing debt at the target level, although that would result in a limitation of the number of non-banks to 10 for that portion of the debt in any event). However, since the proceeds of the acquisition debt may be lent on, the Swiss Non-Bank Rules have to be carefully addressed.

Alternatively, an (indirect) pushdown can be achieved by way of an equity-to-debt swap, where equity (freely distributable reserves or even share capital that can be reduced) is distributed (but not actually paid out) and converted into a downstream loan. In recent transactions, additional pushdown of debt potential has been created by some post-acquisition restructuring steps (such as group internal sales of assets generating additional earnings and the respective debt capacity).

If such a pushdown can be achieved, some of the interest incurred on the acquisition debt may be brought to the target company level and become available for set-off against income generated at the target level. The security package structure may be improved in connection with such pushdown at the same time.

III SECURITY AND GUARANTEES

i Standard security package at closing

In leveraged acquisition finance transactions involving Swiss target companies, the acquisition debt portion usually benefits from the share pledge over the top Swiss target company. In most cases, the security package is completed by other security provided by the acquisition vehicle, such as security over:

a claims and rights under the share purchase agreement;
b claims and rights under due diligence reports;
c claims and rights under insurances (in particular, M&A insurances, if any); and
d bank accounts.

Share pledge

Under Swiss law, shares in stock corporations and limited liability companies may be pledged by written agreement and if share certificates have been issued by handing over the certificate to the pledgee (duly endorsed or assigned (as applicable) in blank in the case of registered shares). If certificates have been issued, the handover of such certificates is a perfection requirement for the pledge. While a pledge over shares can be perfected, even if no certificates have been issued, the issuance and handover of certificates it is generally considered to bring the pledgees into a factually stronger position in the event of enforcement. In addition, it is standard that any transfer restrictions in the target company's articles of association are removed. Provisions in the articles of association limiting the representation of shareholders at shareholders' meetings to other shareholders must also be lifted to ensure full flexibility once control over the shares has been gained. Given the lack of control over the target company pre-closing, the issuance of certificates and the amendment of the articles of association are generally accepted as conditions subsequent.

Claims and receivables

Claims and receivables (claims under the share purchase agreement, insurance claims, claims under due diligence reports, etc.) may be assigned under Swiss law for security purposes by means of a written agreement between assignor and assignee. The agreement must specify the relevant claims and may cover future claims as well, provided claims are described in a manner that allows for clear identification once such claims come into existence. However, it must be noted that claims arising post-bankruptcy with a Swiss assignor would no longer be validly assigned and would be trapped in the bankrupt estate.

While assignability is generally given under Swiss law in the event that the underlying agreement is tacit as regards or explicitly allows for an assignment, it is important that the underlying agreement does not contain a ban on assignment. Therefore, during the pre-signing phase, the parties must ensure that all relevant documents do not contain any restrictions on assignment (particularly the share purchase agreement, insurances, etc.) and, for the sake of clarity, it is even recommended that important agreements explicitly allow for an assignment for security purposes to financing parties. The same applies to any due diligence reports, although getting the benefit through reliance will also be satisfactory in most circumstances (either directly derived from the report or through additional reliance letters).

Although the requirement to notify third-party debtors (such as the sellers) is not a perfection requirement under Swiss law, it is strongly recommended that such parties are notified of the assignment for security purposes and the transaction as a whole, because a third-party debtor might, pre-notification, validly discharge its obligation by paying to the assignor.

Bank accounts

Security over Swiss bank accounts is typically provided by pledging the claims the account holder has against the account bank. An assignment for security purposes would also be possible (and would even be a slightly more direct security right), but account banks have become increasingly concerned in the past two years about 'know your customer' and beneficial owner identification issues, because the assignment is, legally, a full legal transfer, while the pledge only provides for a limited right *in rem*. Again, a notification of the account bank is not a perfection requirement, but it is standard practice in the Swiss market to notify the account bank and seek its confirmation as to waiving all priority rights in relation to the relevant bank accounts on the basis of its general terms and conditions and otherwise. Such a confirmation should also outline the mechanisms on blocking the account upon further notification.

Timing of providing security on closing

The security interest provided by the acquisition vehicle may be entered into and perfected pre-closing, except for the share pledge, which may only be perfected upon closing of the transaction, immediately after the acquisition of the shares by the acquisition vehicle. From a Swiss point of view, there is nothing that would make it overly burdensome or impossible to perfect the security interest as soon as the transaction is completed or closed. However, some items (such as the amendment of articles of association or notices) will have to become post-closing items, but, as described above, that does not prevent the perfection of the security interest as such.

ii Standard target-level security package

Security is typically granted by the Swiss target companies. The target-level security package is similar to fully fledged security packages in other jurisdictions and may include, *inter alia*, security over:

a shares in subsidiaries;
b trade receivables;
c intercompany receivables;
d insurance claims;
e bank accounts;
f intellectual property; and
g real estate.

See above for a description of security over most of these assets.

However, in smaller transactions and depending on the level of leverage provided, sponsors are sometimes able to negotiate a slimmer security package for purposes of avoiding transaction costs. This is particularly true in pure Swiss domestic deals and in case the taking of security would require involvement of additional foreign counsel.

Real estate

Security over real estate is typically taken by way of taking security over mortgage certificates. A mortgage certificate is issued either in bearer or in registered form. Alternatively, since January 2012, a paperless version of a mortgage note can be created which is evidenced by electronic registration in the relevant land register. A mortgage note creates personal, non-accessory claim against the debtor, which is secured by a property lien. Unless pre-existing mortgage certificates are available, the creation of new mortgage certificates requires a notarised deed and registration of the mortgage certificate in the land register. Once created, the mortgage certificates will be transferred for security purposes under a written security agreement without further notarisation or entry into the land register (except in the case of paperless mortgage certificates).

One important tax point has to be considered as interest payments to non-Swiss resident creditors of loans secured by Swiss real estate are subject to withholding tax at source, unless the lender is located in a jurisdiction that benefits from a double tax treaty with Switzerland providing for a zero rate. Accordingly, if a Swiss borrower is involved, it must be ensured that only 'Swiss treaty lenders' will be secured by real property to avoid the risk of withholding tax being applied to interest payments. Swiss treaty lenders are persons:

a having their corporate seat in Switzerland or are lending through a facility office (which qualifies as a permanent establishment for tax purposes) in Switzerland, and that are entitled to receive any payments of interest without any deduction under Swiss tax law; or

b lending in a jurisdiction having a double tax treaty with Switzerland providing for a zero per cent withholding tax rate on interest payments.

In particular, owing to these tax issues, security over real estate is normally only considered if there is substantial real estate located in Switzerland.

If a foreign borrower is involved (such as a foreign acquisition vehicle), the issue basically remains the same, but an application for an exemption through a tax ruling application may be considered. While such a tax ruling has been obtained very recently in a few cantons, the process of being granted such a ruling in other cantons might be quite lengthy and therefore costly (while the outcome is possibly vague). Without a satisfactory tax ruling, real estate located in Switzerland cannot be granted as security due to the risk of potential withholding tax on interest payments.

Intellectual property

Under Swiss law, security over intellectual property is typically taken by way of pledge. A written pledge agreement is required, specifying the intellectual property right. As a matter of Swiss law, no registration is required for the valid perfection of the pledge over intellectual property. However, if not registered, the intellectual property may be acquired by a *bona fide* third-party acquirer, in which case the pledge would become extinct. While a Swiss law pledge over foreign intellectual property is valid as a matter of Swiss law, it should be double-checked whether the validity of the security interest would also be recognised under relevant foreign law, or whether – as an example – its registration would be a perfection requirement. Accordingly, with regard to foreign intellectual property of certain importance and value, it is advisable to register the pledge in the relevant register. Security agreements typically provide for a registration obligation for the pledge over important intellectual property on day one and for all other intellectual property upon the occurrence of an event of default.

Difficulties in taking security over moveable assets
Due to strict repossession requirements under Swiss law, taking of security over moveable assets (such as an inventory or equipment) without substantially disturbing the daily business of the security provider is difficult. There are structuring solutions surrounding this issue (such as pledge holder structures or Opco or propco structures), but these solutions are usually only implemented in situations where there is a specific focus on a specific asset (raw materials with substantial value, larger car fleets, aircraft parts, etc.).

Timing of providing target-level security
Unless there is some cooperation on the part of the seller to start preparing target-level security pre-closing (and depending on the exact release mechanisms from existing financings), target-level security might only be available post-closing, and it is usually agreed that target-level security might be completed as a condition subsequent.

iii Financial assistance and upstream and cross-stream security/guarantees

Standard upstream and cross-stream limitations will apply to Swiss target-level guarantees and security. Essentially, the amount of proceeds under upstream and cross-stream security or guarantees that is available to lenders is limited to the amount that the guarantor/security provider could distribute to its shareholders as dividends at the point in time of enforcement. In addition, certain formal requirements will have to be followed both, upon granting and enforcement of the security or guarantee. These limitations may affect the security substantially, particularly in situations of financial distress. However, if structured properly and if using all available mitigants, such limitations are generally accepted by investors and lenders.

In October 2014, the Swiss Federal Supreme Court ruled, that upstream and cross-stream loans that do not meet the at arm's-length test will also reduce the distributable amounts. However, at the same time, the Swiss Federal Supreme Court ruled that paid in surplus is generally available for distribution to shareholders. It would appear that parties have applied a more cautious approach around the granting of upstream and cross-stream loans since October 2014, but transaction structures generally remained unchanged. It remains to be seen whether, as a matter of fact, that more restrictive practice will further affect the transactional behaviour of borrowers and lenders and whether further court rulings will be issued in this respect.

If the structure also includes a downstream loan from the acquisition vehicle to the Swiss target companies (often used for tax purposes as a pushdown of debt and for the repatriation of the cash flows), the Swiss target company may provide (unrestricted) security to secure such a downstream loan, because it would secure its own rather than parent debt. Accordingly, this would not qualify as upstream security. The acquisition vehicle in turn may provide security over the downstream loan, along with the (unrestricted) security package securing such a downstream loan. From a Swiss corporate law perspective, there is a good chance that upstream limitations will not apply to that security structure. However, such a security structure should be discussed with the SFTA in the light of the Swiss Non-Bank Rules.

IV PRIORITY OF CLAIMS

i Statutory priority of claims

Upon bankruptcy over a Swiss entity, certain creditors would benefit from statutory priority:

a secured claims are satisfied with priority directly out of the enforcement proceeds; any surplus will be shared among (unsecured) creditors generally, and any shortfall would be treated as a third-class claim; and

b claims incurred by the bankruptcy or liquidation estate or during a debt restructuring moratorium with the administrator's consent rank above unsecured claims.

In relation to unsecured claims, there are three priority classes: the first class mainly consists of certain claims of employees as well as claims of pension funds; the second class consists of claims regarding various contributions to social insurances and tax claims; and the third class consists of all other unsecured claims.

ii Contractual structuring of priority of claims

Within the third class, creditors and the debtor are free to contract on the ranking of such claims among themselves. Typically, in Swiss acquisition finance transactions, the priority of claims among various debt investors is reflected on the basis of intercreditor arrangements rather than on the basis of structural subordination. It should be noted, however, that in larger transactions, the acquisition structure is most often set up outside Switzerland. In addition, where the investor base would expect a structural subordination, such a structure is implemented, but rather for marketing purposes.

Under Swiss law, intercreditor arrangements that provide for the priority of claims are generally binding on the parties involved and also on insolvency officials of an estate. However, given that there are hardly any relevant precedents, it cannot be ruled out that an insolvency official would treat all non-secured creditors indiscriminately as third-class creditors, and consider the priority of payments as a mere arrangement among creditors of the estate in relation to their respective claims in relation to the estate and pay them out on a *pro rata* and *pari passu* basis. Such being the case, the parties to the intercreditor arrangement may have to rely on the redistribution by the creditors among themselves.

iii Equitable subordination

The concept of equitable subordination is neither reflected in codified Swiss law nor well established in Switzerland. Even though there are no conclusive precedents, equitable subordination is generally only discussed in connection with shareholder loans. It is unclear whether the holding of a very small equity stake would be sufficient for a qualification of a loan as shareholder loan. It would appear that the terms of the loan and the circumstances under which it has been granted are more relevant than the specific percentage of shareholding. Against this background, it may be concluded that a loan granted in proportion to the shareholding of a small shareholder (together with all other shareholders) could be problematic, while the holding of a portion in a larger (syndicated) loan (at arm's length) by a bank seems to be unproblematic, even if that bank would hold an equity stake in the relevant Swiss company.

Basically, a parent company will be treated as any other third-party creditor of such Swiss subsidiary in the framework of a Swiss bankruptcy proceeding. The risk of a shareholder loan being deemed to be either subordinated against all other (non-subordinated) creditors, or to be treated like equity (in which case, the parent company would only be satisfied together with all other equity contributors), arises only under very specific circumstances.

Elements that could be relevant are:

a that the shareholder loan is granted in a situation where the Swiss subsidiary is already over-indebted;

b that the parent company had (or should have had) knowledge of the over-indebtedness of its Swiss subsidiary while granting the shareholder loan;

c that the granting of the shareholder loan resulted in the Swiss subsidiary having upheld its business activities, and accordingly in a deferral of the opening of bankruptcy proceedings over the Swiss subsidiary; and

d that the deferral of the opening of bankruptcy proceedings results in a (potential) damage of other creditors of the Swiss subsidiary.

A few scholars suggest applying a stricter regime (*per se* subordination of shareholder loans in bankruptcy; application to the concept to third-party loans, etc.), but it must be noted that court decisions where the concept of equitable subordination has been applied are fairly rare and, accordingly, that this concept cannot be regarded as well established as such. Therefore, we see little leeway for the application of such a concept, in particular, where loans are granted on an arm's-lengths basis and to Swiss companies that are not over-indebted.

V JURISDICTION

The submission by a Swiss company to the exclusive jurisdiction of the courts of England or any other non-Swiss forum is generally binding on such a Swiss company. It should be noted, however, that under Swiss law, jurisdiction clauses may have no effect as regards actions relating to, or in connection with, insolvency procedures that, as a rule, must be brought before the court at the place of such an insolvency procedure. Furthermore, contractual submissions to a particular jurisdiction are subject to the mandatory provisions on the protection of consumers, insured persons and employees pursuant to the Lugano Convention, the Swiss Federal Private International Law Act (PILA) and such other international treaties by which Switzerland is bound. Pursuant to the PILA and the Lugano Convention, Swiss courts may also order preliminary measures even if they do not have jurisdiction over the substance of the matter.

Enforceability in Switzerland of a foreign judgment rendered against a Swiss company is subject to certain limitations set forth in (1) the Lugano Convention, (2) such other international treaties under which Switzerland is bound and (3) the PILA. In particular, a judgment rendered by a foreign court may only be enforced in Switzerland if:

a (in the case of (2) and (3) and, in certain exceptional cases, (1), the foreign court has jurisdiction;

b the judgment of such foreign court has become final and is non-appealable or, in the case of (1), has become enforceable at an earlier stage;

c the court procedures leading to the judgment followed the principles of due process of law, including proper service of process; and

d the judgment of the foreign court on its merits does not violate Swiss law principles of public policy.

In addition, enforceability of a judgment by a non-Swiss court in Switzerland may be limited if the Swiss company demonstrates that it has not been effectively served with process (a service of process on the Swiss company will have to be made in accordance with the Hague Convention).[3]

VI ACQUISITIONS OF PUBLIC COMPANIES

While the financing of public takeover transactions generally involves the same structural considerations as other leveraged acquisition financing transactions, a number of additional, specific elements arising from the public takeover regime must be considered. One of the main obstacles to overcome under Swiss law is the fact that the Swiss takeover board would not allow an acceptance threshold for the public takeover, which is as high as the level of control needed to proceed with a squeeze-out of minority shareholders and gain 100 per cent control over the target. In the context of financing a leveraged public takeover this constitutes a challenge, because there is a chance that the bidder will be stuck with a majority stake only (i.e., less than 100 per cent).

i Structuring of public tender offers and options for squeeze-outs

Under Swiss law, a public tender offer may contain only limited conditions and, in the event that these conditions are satisfied, the bidder is obliged to complete the transaction. One of the permitted conditions is to include an acceptance threshold (that is, the requirement to complete the transaction when a certain percentage of shares is tendered to the bidder). However, an acceptance threshold of more than two-thirds (66.66 per cent) will require the approval from the Swiss takeover board. Although there is a good chance that this threshold will be pushed to 75 per cent, it is unlikely that the takeover board will accept any threshold above 75 per cent.

Following the completion of a public tender offer (that is, after the lapse of the additional acceptance period), the bidder has the following options available to gain 100 per cent control over the target:

a Squeeze-out merger: under Swiss merger law, a minority squeeze-out is available if the majority shareholder holds at least 90 per cent of the Swiss target shares. A squeeze-out merger is usually effected by merging the Swiss target company with a newly incorporated (and 100 per cent-owned) affiliated company (preferably a sister company incorporated for this purpose). The process for merging the two companies would typically take between three and six months. However, minority shareholders have appraisal rights and can block the recording of the merger in the commercial register, which may delay the closing of the merger and, hence, the entire process. In addition, given the appraisal rights of minority shareholders, it is important to kick off the merger process (and the entry into force of the merger agreement) only six months after the lapse of the additional acceptance period in order to eliminate any risk of being in conflict with the 'best price rule'. Under the best price rule, if the bidder acquires target shares in the period between the publication of the offer and six months after the additional acceptance period at a price that exceeds the offer price,

3 Hague Convention of 15 November 1965 on service of judicial or extrajudicial documents abroad in civil and commercial matters.

this price must be offered to all shareholders; hence, there is a risk that through the appraisal rights that shareholders have in the merger process, a higher price may be determined, which must be potentially offered to all shareholders (also retroactively).

b Squeeze-out under Swiss takeover law: if, following a public tender offer, the bidder holds 98 per cent or more of the Swiss target shares, a squeeze-out of minority shareholders may be initiated. This process takes two to three months and involves a court ruling. The 98 per cent level must be reached within three months after the additional acceptance period has expired. Contrary to a squeeze-out merger, minority shareholders have no appraisal rights as they receive simply the offer price. Similarly, blocking the recording in the commercial register is not possible as the commercial register is not involved.

Following the completion of a public tender offer, if the bidder holds less than 90 per cent of the Swiss target shares, no squeeze-out will be available. Although the bidder may try to buy additional shares over the market (the best price rules will have to be closely monitored), or an additional public tender offer may be launched, there is no absolute certainty that the bidder would achieve 90 per cent. Once the 90 per cent threshold has been reached, a squeeze-out merger will become available again.

ii Certain funds requirements

Under Swiss law, certain funds requirements can be summarised as follows:

a certain funds must be available on the launch of the offer (i.e., publication of the final offer and the offer prospectus), and certain funds must be confirmed by a special auditor (it is, however, prudent for a bidder to ensure certain funds upon pre-announcement of the offer already, because the bidder must proceed with the offer within six weeks of the pre-announcement being published); and

b the offer prospectus must provide for financing details and confirmation from the special auditor.

Typically, only the very basic terms of the financing will have to be disclosed in the offer prospectus, and it would not be necessary to disclose details on pricing and fees and similar commercial terms.

Given the certain funds requirements, the financing may only contain limited conditions precedent. The Swiss takeover board has issued guidelines in this respect (it should be noted that supervisory authorities and courts are not bound by such guidelines, but the guidelines are still generally considered an important indication) and, according to these, the following conditions are generally acceptable:

a conditions that match the conditions contained in the offer;

b material legal conditions relating to the bidder, such as status, power, authority, change of control;

c conditions relating to the validity of finance documents, in particular security documents and the creation of security thereunder;

d conditions relating to material breaches of agreements by the bidder, such as *pari passu*, negative pledge, no merger, non-payment; and

e material adverse changes in relation to the bidder.

Generally, however, market and target material adverse change clauses are not permitted.

iii Consequences on financing and further considerations

Potential financing structures

Given the required structure of a public tender offer, the financing must be available and committed even though it is not absolutely certain that the bidder would ever gain 100 per cent control over the target. This situation is quite challenging from a financing perspective. This challenge could be approached in two ways:

a one approach could be to simply apply a more conservative overall leverage; however, this might affect the overall economics of the transaction considerably, and will ultimately influence the bid price and the chances of the tender offer of being successful; or

b alternatively, two different financing structures could be prepared.

The difficulty in preparing two financing structures is that parties would only know the exact structure upon the lapse of the additional acceptance period; hence, it might be challenging for the arrangers and book-runners, as there will only be a limited amount of time available between the lapse of the additional acceptance period and the close of the transaction for purposes of marketing the financing transaction.

If the bidder holds at least 90 per cent of the Swiss target's shares, the period from the first drawdown to the point where the bidder controls 100 per cent will still take a couple of months. In the squeeze-out merger scenario, it is prudent to wait until the best price rule has lapsed before entering into the merger agreement, as this would eliminate the risk of a successful appraisal action having retroactive effect on the offer price in the public tender offer (violation of the best price rule). Accordingly, it can be expected that the merger will be completed within eight to 10 months after the lapse of the additional offer period, but it is prudent to add an additional two months as a minority shareholder could potentially delay the process.

Interim period

While minority shareholders are in the structure, access to target-level cash flows is limited because it is difficult to structure upstream loans to a majority shareholder in a manner compliant with the principle of 'equal treatment of shareholders', and any leakage of dividends to minority shareholders should be avoided (this is true for two reasons: first, any leakage to minority shareholders would result in the bidder incurring a cash drain; and second, if the market ever found out that there were a chance for dividends to be paid *ad interim* (and any person involved in the structuring of the financing knew about this), this would be a bad sign for the success of the tender offer). Therefore, the transaction will require some overfunding to ensure a proper debt servicing during the post-closing period, when target-level cash flows are not available.

Furthermore, target-level security is not available in the interim period, because that would again raise questions under the principle of 'equal treatment of shareholders'.

In addition, while the Swiss target company is still publicly listed, it is subject to *ad hoc* publicity obligations and, accordingly, information may only be provided to all investors at the same time, and any pre-information for selected investors might raise concerns. Availability of information to majority shareholders and banks might also be limited due to the concept of equal treatment of shareholders.

Delisting

As demonstrated, the squeeze-out options are limited and essentially only available if the bidder controls 90 per cent or more in the Swiss target company. However, a delisting of the Swiss target company would already be feasible in a scenario where the majority shareholder controls less than 90 per cent. SIX Swiss Exchange's delisting directive was recently amended, and the period between announcement of the delisting and the last trading day will be set by SIX Swiss Exchange between three and 12 months. However, such period may be shortened if delisting occurs following a takeover process.

VII OUTLOOK

The most important change of law currently under discussion that would affect lending in Switzerland generally (and in particular leveraged acquisition finance transactions) relates to Swiss withholding tax. Switzerland is about to consider fundamental changes to its withholding tax system. Draft legislation was already published by the Swiss Federal Council on 24 August 2011. It was expected that the new regime would enter into force during the course of 2015 or 2016. However, in view of the negative outcome of the consultation on the draft legislation in the course of 2014 and 2015, the Swiss Federal Counsel decided on 24 June 2015 to postpone a complete overhaul of the Swiss withholding tax regime, as originally planned. The draft legislation suggested that the current deduction of 35 per cent by the issuer of bonds on interest payments at source would be substituted for a respective deduction by Swiss paying agents (subject, in principle, to an exception for foreign investors). This change should have, among other things, discouraged foreign bond and facilities issuances by Swiss groups and was thus supposed to enhance the Swiss capital market. It now remains to be seen when and, if so, in what form the withholding tax reform will be relaunched. The paying agent principle should be discussed again before the planned exemptions for CoCo bonds, write-off and bail-in bonds expire.

Given the increased level of scrutiny from tax authorities, the pricing of intercompany guarantees (and other security) is likely to become one of the most contentious issues in transfer pricing. Tax authorities on their part will be concerned that corporate guarantee or security fees adequately reflect the heightened business failure and default. Taxpayers will in turn face the arduous challenge of determining what constitutes an arm's-length guarantee or security fee at the time when rules of thumb and quick answers have become less reliable. Given the sums typically involved and the complexity of the issues faced, it will be important to consider multiple approaches in pricing intercompany guarantees and other securities.

Chapter 22

UNITED STATES

Melissa Alwang, Alan Avery, Mark Broude, Jiyeon Lee-Lim and Lawrence Safran[1]

I OVERVIEW

Leveraged acquisitions are typically financed through a mixture of high-yield bonds and term loans, with ongoing working capital requirements provided through cash flow or asset-backed revolving facilities entered into concurrently with the acquisition. Financings utilising term loans and revolving facilities are typically guaranteed by each material subsidiary of the borrower and secured by substantially all the assets of the borrower and each guarantor, and second-lien structures are common. High-yield bond financings are more likely to be unsecured, but are sometimes secured on a first or second lien basis. The sources of funding are broad, including collateralised loan obligations and other institutional lenders, retail loan funds and commercial banks. Recent leveraged lending activity has been very strong, with over US$1.2 trillion in syndicated loans issued in 2014.

II REGULATORY AND TAX MATTERS

i Regulatory issues

Regulatory concerns for debt finance in the leveraged acquisition context typically arise under regulations related to authorisation and sanctions. In addition, certain types of collateral may be subject to special regulations. Some relatively recent regulatory developments in the United States have also had an impact on certain leveraged finance activities of banks.

Required authorisation

Assuming the lender does no other business in the United States, being a lender of record generally does not subject the lender to licensing or other qualification requirements to do business in the United States, although there may be exceptions to this rule from state to

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state. Collection and enforcement activities are more likely to require an entity to obtain a licence and qualify to do business within a state. However, in almost all leveraged acquisition financing, only the administrative agent (or collateral agent) will be acting in the capacity of the collecting or enforcing bank, so these restrictions are generally not a concern for specific syndicate members.

Sanctions

Federal sanctions and anti-money laundering laws require financial institutions to implement due diligence procedures with respect to their customers in order to prevent the transfer of cash to certain prohibited countries and persons.

Collateral-related regulations

Margin loans

If the collateral for the loan consists of securities that are traded on an exchange in the US, or 'margin stock', then the loan may be subject to additional restrictions. Such restrictions, often referred to as the 'margin regulations', limit the amount of loans that can be collateralised by such securities. The US margin regulations can also be implicated by the existence of arrangements that constitute indirect security over margin stock, such as through negative pledge provisions or other arrangements that limit a borrower's right to sell, pledge or otherwise dispose of margin stock.

Government receivables

With respect to collateral consisting of receivables, if the debtor under such receivable is the US government or one of its agencies or instrumentalities, the Federal Assignment of Claims Act will apply to an assignment of receivables and the right of the federal government to exercise set-off. A minority of states have similar laws that apply to obligations of the state or agencies or departments thereof, and a few states extend such rules to municipalities and other local governmental entities.

Regulatory developments – leverage lending guidance

In March 2013, the three US federal banking agencies jointly issued updated supervisory guidance for financial institutions engaged in leveraged lending activities, including acquisition financing. The guidance sets forth enhanced expectations in a number of areas and cautions banks to strengthen their risk management of loans to highly leveraged borrowers. These regulatory developments have curtailed the regulated entities ability to commit to certain highly leveraged transactions.

ii Tax issues

Withholding taxes

The United States generally imposes a 30 per cent federal withholding tax on interest paid to a non-US lender on a debt obligation of a US person. This withholding tax may be eliminated (or reduced to a lesser amount) pursuant to an applicable income tax treaty between the United States and the country in which a lender receiving interest is resident.

Alternatively, a non-US lender may qualify for an exemption from US federal withholding on interest under the 'portfolio interest exemption'. To qualify for the portfolio interest exemption, the debt obligation must be in 'registered form' for US federal income tax purposes; the lender must not be a controlled foreign corporation related to the borrower or a bank receiving interest on an extension of credit entered into in the ordinary course of its trade or business; and the lender must not own, directly, indirectly or by attribution, equity representing 10 per cent or more of the total combined voting power of all voting stock of the borrower (or, if the borrower is a partnership, 10 per cent or more of capital or profits interest of the borrower). In addition, the portfolio interest exemption does not apply to certain contingent interest, such as interest determined by reference to any receipts, sales, cash flow, income or profits of, or the fluctuation in value of property owned by, or dividends, distributions or similar payments by, the borrower or a related person.

The beneficial owner of interest must submit a properly completed IRS Form W-8BEN-E (or, if an individual, IRS Form W-8BEN) to claim an exemption or reduction available under an applicable income tax treaty or the portfolio interest exemption.

If interest paid to a non-US lender is effectively connected with such lender's trade or business in the United States, such interest will not be subject to US federal withholding as long as such lender submits a properly completed IRS Form W-8ECI, but will generally be subject to net income tax in the United States and, for foreign corporations, branch profits taxes.

Additionally, withholding taxes may arise in other circumstances, including the payment of various fees (such as letter of credit fees), modifications to debt obligations, and various adjustments on debt obligations that are convertible into stock.

Foreign Account Tax Compliance Act (FATCA)

Under provisions commonly referred to as FATCA, a 30 per cent withholding tax may be imposed on interest on, and gross proceeds from the sale, redemption, retirement or other disposition of, a debt obligation of a United States person paid to a foreign financial institution or to a non-financial foreign entity, unless the foreign financial institution enters into an agreement with the IRS and undertakes certain investigation, reporting and other required obligations; the non-financial foreign entity either certifies it does not have any substantial United States owners or furnishes identifying information regarding each substantial United States owner; or the foreign financial institution or non-financial foreign entity otherwise qualifies for an exemption from these rules. Foreign financial institutions located in jurisdictions that have an intergovernmental agreement with the United States governing these rules may be subject to different rules. FATCA withholding tax generally applies to payments of US-source interest made on or after 1 July 2014, and to payments of gross proceeds from a sale or other disposition of debt obligations producing US-source interest on or after 1 January 2019.

Deductions

Interest or original issue discount accruing on an obligation properly treated as debt for US federal income tax purposes will be deductible as such interest or original issue discount accrues, subject to applicable limitations. All entities in a group within the US are able to consolidate financials for US federal income tax purposes, and consolidation with members of the group outside the US may be possible with certain 'tax pass-through' entities.

Under the earning stripping rules, if a foreign affiliate guarantees the debt obligation (or if interest is paid to a foreign affiliate) and the debt-to-equity ratio of the borrower exceeds 1.5:1, deduction of interest may be limited to 50 per cent of the adjusted taxable income of the borrower, and any disallowed interest may be carried over to successive years.

Additionally, if a debt obligation is issued with a 'significant original issue discount' for US federal income tax purposes, matures more than five years after the issue date and its yield exceeds certain thresholds, the debt would be treated as an 'applicable high-yield debt obligation,' in which case original issue discount may not be deducted until paid and the deduction of a portion of original issue discount on the debt may be permanently disallowed. Such limitations can be avoided if the debt obligation provides for adequate partial prepayments after the fifth year.

There could be other limitations on deductions if the lender is related to the borrower, or if the debt obligation is convertible or is issued together with equity-flavoured instruments. An affiliated group of US corporations can elect to file a consolidated return, in which case deductions and income of members within the group can generally offset each other.

Credit support

Generally, non-US affiliates that are treated as controlled foreign corporations for US federal income tax purposes will not guarantee the debt obligations of a US borrower, because such a guarantee would result in a deemed dividend to its direct or indirect US shareholders. In addition, to avoid such deemed dividend, no assets of a controlled foreign corporation may be pledged to support the debt obligations of a US borrower, and only up to two-thirds of the voting stock of a controlled foreign corporation may be pledged in support of a debt obligation of a US borrower. US borrowers will ensure that limitations on guarantees and stock pledges to eliminate the potential deemed dividend issues.

III SECURITY AND GUARANTEES

i Guarantees

Guarantees of obligations are typically provided by all material domestic subsidiaries and the direct parent (if any) of the borrower. While there are corporate limitations on the value of guarantees by subsidiaries of the obligations of their parent entities, such limitations do not typically affect the taking of such guarantees, only potentially the value thereof in an enforcement or bankruptcy proceeding. Nevertheless, particularly in the case of non-wholly owned subsidiaries, the organisational documents of guarantors should be reviewed to ensure that any guarantees are within the capacity of the guarantor. In the case of a guarantee that is required by the principal obligations and is being issued contemporaneously with the principal obligation, separate consideration to the guarantor is not required under New York law nor the law of many other states, although laws may vary among the states. Where the guarantee is not contemporaneous with the principal obligation, New York law provides that such guarantee is enforceable as long as any consideration is recited in the guarantee and proven to have been given, and would be valid consideration except for at the time that it was given.[2] The Restatement (Third) of Suretyship & Guaranty takes a similar position, but not all states follow this approach and in some states separate consideration may be required for a guarantee executed after the primary obligation. For example, Section 2792 of the California Civil Code provides that:

2 Section 5-1105 of the New York General Obligations Law.

> *Where a suretyship obligation is entered into at the same time with the original obligation, or with the acceptance of the latter by the creditor, and forms with that obligation a part of the consideration to him, no other consideration need exist. In all other cases there must be a consideration distinct from that of the original obligation.*

In addition, as noted above, except in limited circumstances, because of the adverse tax consequences arising under the US Tax Code, subsidiaries organised outside of the US do not provide guarantees of obligations of a US borrower.

Whether the guarantee is immediately enforceable would depend on the terms of the guarantee. A guarantee of collection would generally require the holder of the guaranteed obligation to first exhaust its remedies against the principal obligor prior to seeking payment from the guarantor (unless the principal obligor is insolvent or the subject of an insolvency proceeding). In contrast, guarantees of payment, which are much more typical, do not require the holder of the guaranteed obligation to pursue its remedies against the principal obligor prior to seeking to enforce the guarantee.

ii Security

Security interests are most commonly taken over substantially all assets (other than real property) in a single security agreement. Such assets may include general intangibles, including contract rights and intellectual property, accounts receivable, goods, including equipment, moveable assets and inventory, securities and securities accounts, and cash deposits. The single security agreement is typically under the law of the state that governs the loan agreement, although the assets intended to be covered by such security agreement may be located outside of such state. Such security interests can, and typically do, also extend to after-acquired assets. Interests in real property, whether owned or leased, need to be addressed in separate mortgage agreements enforceable under the state in which such real property is located. Regardless of the type of security interest, the scope of the secured claim or guaranteed obligation can be a single claim; or a multitude of present or future claims, or both. To specify future secured claims or guaranteed obligations, a general description would suffice provided that these claims are reasonably identified and determinable. The perfection method for each type of these security interests is discussed in more detail below. It is essential to bear in mind that certain transactions, collateral and grantors are excluded from the Uniform Commercial Code (UCC) either in whole or in part. For example, in most cases, perfection of a security interest in titled motor vehicles will require compliance with the applicable state motor vehicles laws. With respect to motor vehicles titled in New York, a lien may be noted on the title by filing the appropriate documents with the Commissioner of the New York Department of Motor Vehicles.

iii Perfection and creation

To create a valid security interest in those categories of collateral governed by the UCC, a grantor must execute or authenticate a written or electronic security agreement that provides an adequate description of the collateral, the grantor must have rights in the collateral or the power to transfer such rights, and value must be given. A security interest in most types of collateral governed by the UCC may generally perfected by the filing of a notice filing under the UCC, referred to as a UCC financing statement.

iv Receivables

In addition to the general rules set forth above, if the receivable is evidenced by an instrument or chattel paper (a receivable secured by a specific good, such as a loan secured by a particular automobile, or a lease of specific goods, such as a lease of an automobile), perfection by possession or control of the instrument or chattel paper is preferable to perfection by a UCC financing statement as possession or control may entitle the secured party to higher priority and protect the secured party from third parties acquiring better rights in the collateral. Possession means physical possession of the original instrument or tangible written chattel paper by the secured party or an agent of the secured party (the grantor cannot be the agent of the secured party for purposes of perfection by possession). In the case of a chattel paper that exists solely in electronic form, an electronic equivalent of possession known as 'control' is legally possible; however, the rules are complex, and counsel should be consulted if this method of perfection is desired. As noted earlier, if the underlying obligor is a federal, state or local governmental entity, compliance with various special laws applicable to such obligors may be necessary or advisable.

v Moveable assets and inventory

Consistent with the general rule, a security interest in inventory and equipment is generally perfected by the filing of a UCC financing statement. For most US corporations, limited liability companies and limited partnerships, the UCC financing statement would be filed in the jurisdiction in which such entity was formed, although there are exceptions for certain entities and certain collateral.

vi Securities and securities accounts

Unlike most other collateral, an oral security agreement with respect to securities and securities accounts can be sufficient in certain circumstances; however, such agreements are exceedingly rare, and a written or electronic security agreement is customary and advisable. The UCC provides separate perfection rules for each of the three methods by which a grantor may hold securities. A grantor may hold securities in the form of certificated securities issued directly to the grantor by the issuer of the security. This is a common way for a parent corporation to hold shares in a subsidiary corporation. Perfection of a security interest in a certificated security can be accomplished by either the filing of a UCC financing statement or by the secured party taking physical possession of the original share certificate either directly or through an agent of the secured party (the grantor cannot be the agent of the secured party for purposes of perfection by possession). Perfection by possession of the share certificate is preferable to perfection by a UCC financing statement as possession entitles the secured party to higher priority and may protect the secured party from third parties acquiring better rights in the collateral. Although an endorsement is not required for perfection, there can be additional priority advantages from obtaining an endorsement, and the endorsement can help facilitate any disposition of the security upon foreclosure thereof. It is customary for the share certificate to be delivered to the secured party accompanied by a stock transfer power duly executed in blank.

Another method of holding securities is in the form of uncertificated interests registered directly on the books and records of the issuer of the security or a transfer agent on behalf of the issuer. Perfection of a security interest in uncertificated securities can be accomplished by either the filing of a UCC financing statement or by the secured party obtaining control thereof. Control can be achieved by the secured party entering into an agreement with the issuer whereby the issuer agrees that it will comply with the instructions originated by the secured party directing the transfer or redemption of the security without further consent by the grantor. Control can also be achieved by the secured party becoming the registered owner of the uncertificated securities, although that is less common. Perfection by control is preferable to perfection by a UCC financing statement as control entitles the secured party to higher priority than a secured party that is perfected solely by the filing of a UCC financing statement, and may protect the secured party from third parties acquiring better rights in the collateral.

The final method of holding securities is through a securities account maintained by a financial institution referred to as a securities intermediary. This is the most common method of holding investment securities (whether debt or equity). The interest of the grantor in the securities maintained in a securities account is referred to as a security entitlement. Perfection of a security interest in these security entitlements can be accomplished by either the filing of a UCC financing statement or by the secured party obtaining control thereof. Control can be accomplished by the secured party entering into an agreement, commonly referred to as a securities account control agreement, with the securities intermediary whereby the securities intermediary agrees that it will comply with the instructions originated by the secured party directing the transfer or redemption of the underlying security without further consent by the grantor. Control can also be achieved by the secured party becoming the owner of the security entitlement on the books and records of the securities intermediary. As with the other methods of holding securities described above, perfection by control is preferable to perfection by a UCC financing statement as control entitles the secured party to higher priority and may protect the secured party from third parties acquiring better rights in the collateral.

It is worth noting that many US companies are not organised as corporations but rather as limited liability companies or limited partnerships. Interests in most limited liability companies and limited partnerships would not be classified as securities under the UCC unless the issuer thereof makes a voluntary election to so treat the membership interests or partnership interests or such interests are publicly traded. If the interests are not securities and are not credited to a securities account they will be 'general intangibles', which can only be perfected by the filing of an appropriate UCC financing statement.

vii Cash deposits

Except as proceeds of other collateral, a security interest in deposit accounts can only be perfected by control, and the filing of a financing statement under the UCC would not perfect such security interest.

If the deposit bank that establishes and maintains the deposit account is the same legal entity as the secured party, then the secured party is deemed to be in control of the deposit account and thus perfected automatically. Historically there has been a question as to whether this automatic perfection was available where the secured party is acting in a representative capacity (e.g., as an agent for its affiliates or a group of lenders). Recent amendments to the official comments support the proposition that automatic perfection should be available even where the secured party is acting in a representative capacity. However, even in such cases, it is common for there to also be a deposit account control agreement both as 'belts and suspenders' and also because a deposit account control agreement has other provisions beyond mere control that may be helpful (clear choice of law rules, rules on set-off, etc.).

In addition to automatic perfection, there are two other methods of control. The more common method for most types of financing transactions would be control by agreement, commonly referred to as a deposit account control agreement, whereby the debtor, the secured party and the deposit bank enter into a written agreement pursuant to which the deposit bank agrees to comply with all instructions issued by the secured party directing disposition of funds in the deposit account without further consent of the debtor.

The final method of control would be by the secured party becoming the deposit bank's customer with respect to the deposit account. This method is not commonly used with respect to operating accounts, but is more common with respect to special accounts that the borrower is not intended to have access to, such as an account cash collateralising a letter of credit.

viii Enforcement

Security interests are immediately enforceable upon the occurrence of an enforcement event, subject to any automatic stay in the event that the grantor is subject to a bankruptcy proceeding. Although a secured party has the option of seeking judicial enforcement of its security interest, there are a variety of 'self-help' remedies available under the UCC without the necessity of judicial action and self-help would be much more common than resorting to judicial remedies. Any enforcement action by a secured party must be done without any breach of the peace and must be commercially reasonable. Various notices are required in connection with any enforcement action. In addition, if the security interest at issue is securities or securities accounts, or both, it is advisable to review the organisational documents of the issuer of the securities as well as the applicable corporate or other law pursuant to which the issuer of the pledged securities was organised in order to determine whether there are any prohibitions, restrictions or consent requirements applicable to the creation of the security interest or the exercise of remedies by the secured party with respect thereto. Enforcement of security interests are, more often than not, accomplished in connection with a proceeding under the US Bankruptcy Code.

ix Bankruptcy and preference concerns

In the event of an insolvency proceeding over a guarantor or the grantor of a security interest, treatment of the guarantees and security interests will depend on various considerations. Importantly, if the security interest is not properly perfected, then it will be set aside. Even if the security interest is properly perfected, guarantees and security may be subject to avoidance by the bankruptcy trustee on a number of theories.

Upstream and cross-stream credit support consist of guarantees and security created by a subsidiary to support the obligations of its parent company or of an affiliate controlled by the common parent company. Both upstream and cross-stream credit support are common in the market and, subject to any restrictions in the organisational documents or under the law under which the entity was formed, such guarantees and security interests are permissible. Despite their widespread use, upstream and cross-stream credit support are subject to certain potential vulnerabilities. The biggest potential vulnerability is that such guarantees or such security interests may be invalidated under federal or state fraudulent conveyance laws. Under the fraudulent conveyance provisions of the Bankruptcy Code and under similar state fraudulent conveyance laws, even absent fraudulent intent, an upstream or cross-stream guaranty, as well as any security interest securing such guaranty, may be voidable as a fraudulent transfer if the provider of such guarantee or security interest receives less than 'reasonably equivalent value' in exchange for taking on the credit support obligations and such provider was insolvent at that time or as a result of the transfer (the incurrence of an obligation, including subsequent extensions of credit, is treated as a transfer); was engaged in a business for which it had unreasonably small capital; or intended to incur or believed it would incur debts beyond its ability to repay. Certain transfers made or obligations incurred with actual intent to hinder, delay or defraud creditors may be avoided whether or not the transferor received reasonably equivalent value or fair consideration for the transfer or obligation. Additionally, New York or other state laws contain fraudulent conveyance provisions that are very similar to those under the Bankruptcy Code.

One significant risk to be aware of are the facts that could cause the security interest to be viewed as a preference. In general, a security interest that is granted in respect of antecedent debt (that is, debt that precedes the creation of the security interest) or that is granted substantially simultaneously with the incurrence of the debt being secured but not perfected within 30 days of the creation of the security interest would be at risk of being set aside as a preference if, in either case, the grantor filed for bankruptcy within 90 days of the security interest becoming perfected (or one year if the beneficiary of the security interest is an 'insider' of the grantor). If the security interest in question is granted substantially contemporaneous with the incurrence of the debt being secured and is perfected within 30 days of its creation, then it is generally exempt from attack as a preference.

IV PRIORITY OF CLAIMS

i Priority generally

Assuming that the security interest is properly perfected and is not avoided, then the secured party will be entitled to receive the value of its interest in the collateral up to the amount of its secured obligations, ahead of any other claims against the borrower. The value of a secured party's interest in its collateral is generally the value of the collateral less the amount of any obligations secured by a security interest or lien that is senior in priority under applicable state law. All properly perfected secured claims would be paid (up to the value of the collateral securing such claims) prior to the payment of any unsecured claims or claims secured by a security interest that is junior in priority either under applicable law or (as discussed below) by contract. In addition, various administrative and other claims given priority by law would be satisfied prior to the payment of any unsecured claims. No parties (including governmental agencies and employees) are given any automatic statutory priority over secured creditors as a result of the US Bankruptcy Code. The status and priority of secured creditors are determined almost exclusively by reference to applicable non-insolvency law, and the Bankruptcy Code generally does not affect such status and priority. Under the Bankruptcy Code, the bankruptcy court may grant a security interest with priority over all other security interests to a lender providing new financing to the borrower; however, such security interests may only be granted if either the lenders being primed by the new security interest consent, or if the bankruptcy court decides that the terms of the transaction provide the lenders being primed with adequate protection – a judicial determination that the recovery of the lenders being primed on the secured claims should not be negatively affected by the new financing and security interest.

Under non-bankruptcy law, a properly perfected security interest generally will have priority over a later-filed tax lien in favour of the United States for federal income taxes if the collateral is in existence on the date of the issuance of the federal tax lien or, subject to certain conditions, arises within 45 days of the filing of the tax lien. The United States will generally have priority over collateral (e.g., inventory and receivables) arising more than 45 days after the filing of the tax lien, and the United States would also have priority in all collateral if the tax lien predated the security interest. The rules applicable to various other federal and state governmental liens vary, and an examination of the particular lien law would be required.

ii Equitable subordination

Equitable subordination is generally not an issue except under specific fact patterns. Those facts usually include a lender with an equity position in the borrower using that equity position to advantage its lending position to the detriment of other creditors. The facts supporting equitable subordination can also include other inequitable conducts that the bankruptcy court determines are sufficiently extreme and have caused damage to the borrower sufficient to warrant an equitable remedy – for example, where a competitor of the borrower acquires the loan and then deliberately obstructs the reorganisation process in the hopes of forcing the borrower to liquidate.

iii Treatment of intercreditor or subordination agreements

Section 510(a) of the Bankruptcy Code specifically provides for the enforceability of 'subordination agreements' during a bankruptcy case. Thus, intercreditor and subordination agreements are generally enforceable in bankruptcy to the same extent that they are enforceable under state law. A bankruptcy court will generally enforce the parties' agreement as to the priority of their respective claims (whether secured or unsecured). A bankruptcy court will also enforce many (although not all) of the waivers of rights under the Bankruptcy Code that junior secured parties typically agree to in second-lien transactions.

V JURISDICTION

The US is a multi-jurisdictional country, and the loan agreement needs to select the law of a particular US state (rather than federal law) as the governing law. The choice by the contractual parties of a particular state's law to govern a contract may not be given effect if it does not bear a reasonable relationship with the transaction or parties. A few states, such as New York, permit the choice of their law to govern a contract even in the absence of any contacts if the contract satisfies certain dollar thresholds; however, another US state may not respect this choice of law if litigated in the other US state in the absence of a reasonable relationship.

Each state has somewhat different considerations in determining whether to give effect to a choice of law (other than the law of the applicable state). Typically, such a choice of law will be given effect if:

a the chosen law has a reasonable and substantial relationship and sufficient contacts with the underlying agreement or the transaction contemplated thereby, and the chosen law has the most significant contacts with the matter in dispute;

b application of the chosen law does not violate or contravene, nor is contrary or offensive to, a public or fundamental policy of the state or of such other jurisdiction whose law would apply in the absence of an effective choice of law by the parties to the underlying agreement (which may be another US state or a foreign jurisdiction);

c the chosen law was not induced or procured by fraud; and *d* the matter of law for which the chosen law is to be applied has been previously addressed by the chosen law, and the chosen law differs from the law that would be applied in the absence of the chosen law.

Under the Restatement (Second) of Conflicts of Law, a court may decline to apply the law of a jurisdiction chosen by the parties to a contract (which may be another US state or a foreign jurisdiction) when it is necessary to protect the fundamental policies of the state, the law of which would otherwise apply; and such state has a materially greater interest in the determination of a particular issue than the state of the chosen law.

VI ACQUISITIONS OF PUBLIC COMPANIES

i Methods of acquisition

Acquisitions of public companies are generally accomplished through one of two methods. The first is a consensual process by which the board of the target and the acquirer approve the acquisition and then solicit approval of the transaction by a majority vote of shareholders. The second is to consummate the acquisition through a direct tender offer for the shares followed by a squeeze-out merger of any remaining minority holdings. A tender offer will not require the approval of the target board to be commenced and may be adversarial. While there are considerable federal regulatory requirements relating to public company takeovers as well as significant state laws that will affect the structuring of the acquisition, other than the margin regulations mentioned earlier, such rules are not directed at the financing. The limited conditionality of such financing that is typically found is driven by both the competitive dynamics among potential bidders and the fiduciary duties of the board to approve the 'most certain' transaction.

ii Disclosure of financing terms

As part of the public disclosure required for the solicitation of votes on a merger agreement or the solicitation of shares pursuant to the tender offer, a generic sources and uses, which would include fees, must be provided. Market flex terms generally do not need to be disclosed.

iii Confidentiality prior to consummation of acquisition

Prior to consummation of the acquisition, securities rules that apply to material non-public information (MNPI) would limit any potential lender from trading in the debt or equity securities of the target if in possession of MNPI. Syndication processes are generally structured to allow lenders who do not wish to receive such MNPI to have access only to materials that do not contain MNPI.

iv Margin regulations

Financing of acquisitions of public companies, including take-private transactions, can often raise issues under the US margin regulations discussed above. Even in the absence of a pledge of publicly traded securities, certain transaction structures can create a presumption of indirect security over such securities. The existence of such indirect security can trigger the margin regulation restrictions on the amount of credit that can be extended, either as loans or debt securities.

VII OUTLOOK

The market continues to be robust. Term loan investors continue to support covenant-lite transactions and, in many cases, the credit agreement package of covenants will almost fully mirror a high-yield bond indenture. The Leveraged Lending Guidance provided by certain banking regulators on 21 May 2013 has had a significant impact on reduced leverage overall and the careful scrutiny of some terms. The regulators, the office of the Comptroller of the Currency, the Federal Reserve and the Federal Deposit Insurance Corporation have jurisdiction over many, but not all, of the market participants that arrange and syndicate the loans typically used in the leveraged acquisition market. The Leveraged Lending Guidance has put pressure on the regulated institutions to ensure that the deals brought to market have certain metrics, including repayment through cash flow and leverage limitations consistent with industry profiles.

Appendix 1

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Melissa Alwang is a partner in the New York office of Latham & Watkins. She is a member of the finance department and the banking practice. Ms Alwang has advised a broad range of US and European banks and financial institutions in financing both US and European leveraged acquisitions. Her practice focuses primarily on the representation of major financial institutions in complex multi-jurisdictional leveraged finance transactions and includes international financings, acquisition financings, margin-loan financings, debtor-in-possession and exit financings, shariah-compliant financings and asset-based facilities.

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His practice experience also includes advising local and international clients on all aspects of corporate law, in particular, the structuring of transactions and corporate reorganisations.

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Mr Broude represents pre-petition and post-petition lenders in workouts and Chapter 11 cases; bondholders, both individually and formal and informal committees; and potential acquirers of assets of companies in Chapter 11, both under Section 363 and pursuant to plans of reorganisation, as well as statutory committees.

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Andreas Diem is a partner in the Munich office and chair of the German finance department. He advises lenders and borrowers on the financing of acquisitions, real estate portfolios and NPL portfolios. In addition, he advises clients on syndicated loans and debt restructurings.

Dr Diem is continually 'recommended' for bank lending and acquisition finance by *JUVE*, the *Legal 500 EMEA, IFLR1000* and *Chambers Europe*. In *Handelsblatt Best Lawyers 2017*, he is listed among the 'best lawyers' for banking and finance. Clients praise his technical knowledge, saying: 'Everyone reads and refers to his book on lending.' (*Chambers Europe Germany 2016*). He is the author of the leading textbook on acquisition finance (*Akquisitionsfinanzierungen – Kredite für Unternehmenskäufe*, 3rd edition 2013, CH).

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Ms Jacques has specific experience of advising financial institutions, lenders, investors, alternative capital providers, asset-based lenders and private equity funds on borrowings, new lending, restructurings, workouts and enforcements of debt and equity positions. She provides strategic advice in the enforcement process of loans to servicers, sellers of loans and mortgage-backed securities as well as to investors owning or acquiring stressed or distressed assets.

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Dr Jahn is listed as a 'recommended' lawyer for bank lending and acquisition finance in *JUVE 2015/2016*. He is recognised as an 'up and coming counsel' for banking and finance and as a 'foreign expert' for China (*Chambers Europe Germany 2016, Chambers Global 2015*). Clients say: 'He is good at explaining things to non-lawyers, and not emotional, which is important in negotiations.' (*Chambers Europe Germany 2016).*

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Ragnar Johannesen is an English law-qualified solicitor based in Latham & Watkins' Moscow office, specialising in banking and corporate finance, with a particular focus on event-driven transactions, restructurings, and structured and limited recourse financings (including structured trade and export financings). He has experience in transactions involving multilateral financial institutions, development banks and export credit agencies. Mr Johannesen has been identified as a 'leading individual' in the Russian market by *Chambers Global* since 2012.

CHRISTOPHER KANDEL

Latham & Watkins LLP

Christopher Kandel is co-chair of Latham & Watkin's global banking practice group and specialises in complex international acquisition and leveraged finance transactions. He is distinguished in the London market as one of the few lawyers with partner-level experience and expertise in handling leveraged finance and restructuring matters under both English and US law, and is recognised as a leading lawyer in legal directories including *Chambers UK* (2016 edition tier 1 individual ranking), the *Legal 500* (2016 edition 'Leading Individual' ranking) and *IFLR 1000* (2016 edition 'Leading Lawyer' ranking), and by inclusion in Euromoney's *Guide to the World's Leading Banking Lawyers*, *Who's Who in the World* (Marquis) and *Who's Who in America* (Marquis).

During Mr Kandel's career, he has advised on many landmarks, including numerous European acquisition financings including the largest European LBO financings of the past year (Pirelli), the first super senior revolving facility agreement in Europe, the first *pari passu* senior secured bank facility/senior secured notes issue in Europe, the largest LBO financing in Asia, the largest high yield in Asia and the first western-sponsor style leveraged buyout financing in Russia.

TOMASZ KAŃSKI

Sołtysiński Kawecki & Szlęzak

Tomasz Kański graduated with a law degree from Poznań University Law School. He pursued studies on international business law at the Central European University in Budapest and the University of California in Berkeley as a Stefan Batory Foundation scholar. He also received a master of laws (LLM) degree from the Central European University in Budapest. He joined SK&S in 1995 and became partner in 2002. He has advised in numerous M&A, commercial and international business transactions, including restructuring, privatisation, and bankruptcy projects, as well as corporate disputes. He has also advised numerous clients in their investments in Poland as well as their day-to-day operations, including direct greenfield project investments in special economic zones in Poland. A member of the supervisory boards of several companies, he also frequently publishes in the most recognised Polish professional daily, *Dziennik Gazeta Prawna*.

DAVID KIRKLAND

Gilbert + Tobin

David Kirkland is a senior associate in Gilbert + Tobin's banking and infrastructure group. His practice is primarily focused on leveraged and acquisition finance transactions, both local and international. In this area, he has advised lenders, borrowers and sponsors across a number of transactions including secured, unsecured, syndicated and club loan arrangements. Mr Kirkland's experience also extends to general corporate finance, capital markets transactions and asset-backed lending arrangements, including margin loans, as well as restructurings.

In addition to his time at Gilbert + Tobin, he has worked in the London offices of two large international firms.

Mr Kirkland holds a bachelor of laws degree with first-class honours from the University of Technology, Sydney. He is admitted as a solicitor of the Supreme Court of New South Wales, and has also been admitted to the Roll of Solicitors in England and Wales and as a solicitor of the Supreme Court of England and Wales.

ERIC-GÉRALD LANG

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Eric-Gérald Lang concentrates on tax law, with a specific focus on corporate tax, restructuring and VAT. He started his career as a tax lawyer at NautaDutilh in 2006 before joining Strelia in 2013.

Mr Lang obtained a law degree from the Université libre de Bruxelles (ULB) in 2005 and a master's degree in tax from the ULB in 2006.

JIYEON LEE-LIM

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Jiyeon Lee-Lim is a partner in the New York office of Latham & Watkins and is a member of the firm's tax department. Her major practice area includes international and corporate tax, with a particular emphasis on financial products, capital markets transactions, securitisation transactions and cross-border tax planning. Ms Lee-Lim previously served as head of the firm's international tax group.

Ms Lee-Lim has represented a large number of US and multinational financial institutions in connection with a wide range of financing transactions and debt and equity derivatives, and advised many investment managers in asset-backed securities offerings and other structured finance transactions. She has also represented numerous US and international corporations in connection with private and registered securities offerings as well as corporate reorganisations and international tax planning, and has advised sovereign investors in connection with inbound investments.

Ms Lee-Lim has been on the executive committee of the tax section of the New York State Bar Association (NYSBA) since 2003, and is a co-chair of the NYSBA tax section committee on securitizations and structured finance.

TIMO LEHTIMÄKI

Waselius & Wist

Timo Lehtimäki is a partner in the firm's banking and finance practice group. He has a particular focus on complex, cross-border transactions. His client roster includes numerous leading international banks, other lending entities, private equity houses and corporates whom he advises in their Finland-related matters. His key areas of expertise include conventional bank lending and ABL transactions as well as high-yield bond issuances. He has represented senior and mezzanine lenders in various distress and enforcement scenarios, including pre-pack financial restructurings.

Mr Lehtimäki joined Waselius & Wist in 2007 and was appointed partner on 1 January 2013. He has gained increased visibility in the Finnish market and has been recognised as 'up and coming' by both *Chambers Global* and *Chambers Europe* and a 'rising star' by *IFLR1000.*

GONÇALO VEIGA DE MACEDO

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Gonçalo Veiga de Macedo is a counsel in the banking and projects department at Linklaters' Lisbon office. He represents financial institutions and companies in domestic and international financing and structured finance transactions including sale of loan portfolios, acquisitions, syndicated and real estate finance, project finance, restructuring and insolvency, and transactions in connection with banks deleveraging. Mr Macedo was a PhD researcher at the New University of Lisbon Law School.

KARL MAH

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Karl Mah is a tax partner in the London office of Latham & Watkins. He acts for a broad range of corporate and financial clients, and has particular expertise in advising on the tax aspects of M&A and private equity transactions, financings and corporate restructurings. He was awarded the prestigious Institute Medal and LexisNexis Prize by the Chartered Institute of Taxation for achieving the highest score in the country in the May 2008 Institute examinations, which are considered to be the gold standard among tax professionals in the United Kingdom. He is currently a member of the Chartered Institute of Taxation. Mr Mah is currently recognised as a 'superb technical practitioner who understands his clients' objectives' in the *Legal 500*, and was named in *Financial News*' 2015 list of the brightest up-and-coming European lawyers aged under 40.

THOMAS MARGENET-BAUDRY

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Thomas Margenet-Baudry is a partner in the Paris office of Latham & Watkins and a member of the firm's corporate department. He concentrates his practice on capital markets transactions, with a focus on high-yield debt and equity securities, including in the context of acquisition financing and refinancing. He also has a broad experience in French tender offer regulation and public company representation.

EDGAR MONTEIRO

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Edgar Santos Monteiro is an associate in the banking and projects group in the Lisbon office. His professional practice focuses on the fields of banking and project financing – notably in the energy, infrastructure and services sectors – advising sponsors, lenders and public entities. More recently, he has also worked in the areas of acquisitions and restructuring of businesses and assets. In the previous years his work experience has focused both in Portugal and in lusophone Africa, including Mozambique, Angola and Cape Verde.

Mr Monteiro has a master's degree in business law from the Autonomous University of Madrid.

YUSUKE MURAKAMI

Mori Hamada & Matsumoto

Yusuke Murakami is a senior associate in the finance department of Mori Hamada & Matsumoto, where he focuses on leveraged finance, project finance, securitisation and other bespoke structured finance transactions. He has advised a wide range of borrowers and issuers, as well as major banks and securities companies, as lenders or arrangers in both domestic and cross-border transactions.

He was seconded to the banking department (leveraged and project finance) of Allen & Overy LLP in London from 2012 to 2013.

He is a graduate of Harvard Law School (LLM, 2012) and the University of Tokyo (JD, 2006 and LLB, 2004). He is admitted to the Bar in Japan and New York. He speaks Japanese and English.

DAVID NADLER

Goodmans LLP

David Nadler is a partner in the banking and finance law group at Goodmans. His practice focuses on financing and corporate transactions. He represents leading Canadian and foreign banks and non-bank lenders and debtors in complex domestic and cross-border syndicated lending transactions, and has been involved in several debt restructurings representing creditors and debtors. He also practises with Goodmans' hospitality law group, representing owners and operators of hotels. He is recognised as a leading practitioner of banking and finance law by Euromoney's *Guide to the World's Leading Banking Lawyers* and *The Best Lawyers in Canada*, and has been recognised by *Chambers Global* and *IFLR1000*. He was admitted to the Ontario Bar in 1993.

ANDREA NOVARESE

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Andrea Novarese is a partner in the Milan and Rome offices of Latham & Watkins. He is also European chair of the firm's automotive industry group. His practice focuses primarily on the representation of commercial and investment banks, borrowers and issuers, financial institutions, blue-chip companies and investment firms as well as automotive industry players. He is regularly recognised as a leading lawyer in various legal directories including *Chambers Global* (2015 edition: band 1 individual ranking for banking and finance and band 2 individual ranking for restructuring and insolvency), where he is commended as 'an unquestionable market leader'.

Representative experience includes the €6.8 billion financing of Chem China's bid for Pirelli, the €8 billion financing of the tender offer on Autostrade and the €2 billion restructuring of Sorgenia's debt.

BRENDAN O'NEILL

Goodmans LLP

Brendan O'Neill is a partner in the corporate restructuring group at Goodmans. He has significant experience in cross-border and transnational insolvencies and restructurings, US Chapter 11 reorganisations, Canadian CCAA and CBCA restructurings, out-of-court restructurings and workouts, mass tort restructurings, bankruptcy-based acquisitions, bankruptcy-based litigation and near-insolvency investing scenarios. He is a frequent lecturer on domestic and cross-border insolvency and restructuring matters and serves on various committees for INSOL International. He has been recognised by *Chambers Global, IFLR 1000*, the *Globe & Mail*'s Report on Business, *Lexpert* and *The Best Lawyers in Canada*. In 2009, *Lexpert* recognised Brendan as one of Canada's 'Top 40 Lawyers Under 40'. He was admitted to the New York Bar and the Ontario Bar in 2000.

MARIA PAJUNIEMI

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Maria Pajuniemi is a senior associate in the firm's banking and finance practice group. She specialises in cross-border financing, advising lenders and borrowers alike. Her expertise focuses on the Finnish aspects of English and US law-governed syndicated leveraged and acquisition financing transactions, including high-yield debt products and related bridge financing. Ms Pajuniemi has also gained experience by working at the securities/corporate department of a leading US law firm. She joined Waselius & Wist in 2012.

FERNANDO R DE ALMEIDA PRADO

Pinheiro Neto Advogados

Fernando R de Almeida Prado is a partner in the corporate area of Pinheiro Neto Advogados in Brazil, focusing on providing legal advice to local and foreign financial institutions in a number of areas including M&A, acquisition finance and LBOs, structured finance, aircraft finance, restructuring, derivatives and general regulatory matters. Mr Prado holds an LLB from the Mackenzie University Law School in São Paulo. He joined Pinheiro Neto in 1986 and became partner in 1998. In 1996, he worked as a secondee at Linklaters in London, covering international finance and corporate areas.

CHARLIE PYWELL

Conyers Dill & Pearman

Charlie Pywell joined the corporate department of Conyers Dill & Pearman in the Cayman Islands in 2014, having previously worked as a finance associate in London with Macfarlanes and Latham & Watkins.

He has a broad corporate practice with particular expertise and focus on corporate finance (including fund finance and leveraged finance), M&A and capital market transactions. He regularly advises investment banks, institutional lenders, private equity funds and large corporates on the Cayman Islands law aspects of their cross-border transactions.

IVÁN RABANILLO

Latham & Watkins LLP

Iván Rabanillo is a tax counsel based in Madrid and for more than 15 years he has been advising multinational groups, financial institutions and private equity sponsors in some of the most sophisticated and cutting-edge transactional tax matters in the Spanish marketplace, advising on Spanish and international tax aspects of cross-border M&A, financing transactions, capital markets offerings and restructuring transactions. He holds an LLB degree from the Universidade Salvador (Brazil) and a master's degree in taxation from the Universitat de Barcelona (Spain). In addition, Mr Rabanillo holds an LLM degree in international taxation from New York University School of Law (having pursued such studies after being awarded a full merit scholarship by the La Caixa Foundation, one of the most prestigious scholarship programmes in Spain). He joined Latham & Watkins in 2009, and he worked previously at Arthur Andersen (in Brazil), Garrigues Abogados (in Spain) and Cleary Gottlieb Steen & Hamilton (in New York). He is a recommended lawyer by *The Legal 500 EMEA 2015* (and praised as an 'authentic tax artisan' therein), *Latin Lawyer 250 2015* and *Tax Directors Handbook 2015*. He is admitted to practise law in Spain, Brazil and the state of New York.

OLIVIA RAUCH-RAVISÉ

Latham & Watkins AARPI

Olivia Rauch-Ravisé is a partner in the Paris office of Latham & Watkins and chair of the Paris tax department. She has strong expertise in domestic and cross-border transactional tax law, notably in the private equity and mergers and acquisitions areas, the taxation of capital markets transactions, financial instruments and structured financings.

JACQUES RICHELLE

Strelia

Jacques Richelle is a partner at Strelia and has a wide experience in banking (including acquisition finance, property finance and public entities finance), project finance, structured finance (including securitisation), debt capital markets (including stand-alone issues and EMTN programmes), derivatives and banking and financial regulatory matters. He advises foreign and Belgian banks, as well as borrowers and issuers, in many cases in the context of cross-border transactions.

Before joining Strelia in November 2014, Mr Richelle was a partner at Linklaters (1998–2012) and DLA Piper (2012–2014).

He obtained his law degree from the Université libre de Bruxelles (ULB) in 1988, participated in the summer programme at Duke University School of Law (1988) and obtained an LLM from SMU School of Law in Dallas in 1989.

PAULA RÖTTORP

Hannes Snellman Attorneys Ltd

Paula Röttorp is a partner in the finance group at Hannes Snellman in Stockholm. She advises extensively on acquisition and leveraged finance, but also on project financing of infrastructure, real estate financing, and restructuring of existing loans and assets within and outside insolvency situations. She has broad experience of managing large projects and negotiating agreements for private equity investors, and has extensive experience gained from representing lenders and borrowers alike.

LAWRENCE SAFRAN

Latham & Watkins LLP

Lawrence Safran is a partner in the New York office of Latham & Watkins. Mr Safran is a member of the firm's finance department and the aircraft finance, banking, project finance and structured finance and securitisation practices. These areas include a wide variety of commercial law issues. Special emphasis is placed on those issues arising under Article 9 (secured transactions) and Article 8 (investment securities) of the Uniform Commercial Code, although the practice also includes Article 2 (sales of goods), Article 3 (negotiable instruments), Article 5 (letters of credit), Article 6 (bulk sales) and Article 7 (documents of title).

Mr Safran advises clients on commercial law and personal property transfer issues in connection with credit facilities, second-lien bond transactions, project financings, real estate securitisations, collateralised debt obligations, credit card and other receivables financings and other structured financing arrangements.

BORYS SAWICKI

Sołtysiński Kawecki & Szlęzak

Borys Sawicki has participated – advising both lenders and borrowers – in a large number of cross-border and domestic bilateral and syndicated, secured and unsecured financings where private banks (including GE Corporate Finance Bank SAS, Deutsche Bank AG, the Royal Bank of Scotland plc, Swedbank AB, Bank of America, Raiffeisen Zentralbank Österreich AG, ING Bank NV, BNP Paribas, Credit Suisse First Boston, Wells Fargo Bank, National Association and Citibank International plc) have extended loans to Polish and international borrowers. In all those transactions he has actively participated in the structuring and negotiating of financing agreements and has structured respective security documents.

Mr Sawicki has also worked closely for several years with the European Bank for Reconstruction and Development, providing advice in the fields of project finance, local self-government regulations (including public finance regulations), public aid and public procurement laws. He has also advised the World Bank on matters related to the structuring and establishment of a security package to secure financing extended by the World Bank to a municipally owned district heating company. In 2009, he advised on the securitisation of commercial receivables (aggregate value of €300 million) of a group of food-producing companies, as well as in a number of aircraft acquisition finance transactions. In the field of corporate law, Mr Sawicki has successfully completed a number of mergers and acquisitions of entities of various sectors (recently, of one of the largest Polish courier services providers) and provides day-to-day corporate advice to numerous clients of the firm.

JOHN SCHEMBRI

Gilbert + Tobin

John Schembri is the head of Gilbert + Tobin's banking and infrastructure group. His major area of practice is leveraged and acquisition finance, together with structured and project financing. He also has significant experience in various other areas, including the financing of construction and resources projects, property, acquisition and general corporate financing.

Mr Schembri's experience also extends to corporate debt and leveraged finance transactions, including the financing of specific asset acquisitions as well as funding general working capital requirements. In this area, he has acted for both lenders and borrowers and in secured, unsecured, syndicated and club loan arrangements.

He is recognised as a leading banking and project finance lawyer in numerous publications including leading directories such as *Chambers*, *The Legal 500*, *Best Lawyers* and *IFLR1000*.

Mr Schembri holds a bachelor of arts degree, a bachelor of laws degree with first-class honours and a master of taxation degree from the University of Sydney. He is admitted as a solicitor of the Supreme Court of New South Wales and the High Court of Australia, and has also been admitted to the Roll of Solicitors in England and Wales and as a solicitor of the Supreme Court of England and Wales.

NAOYA SHIOTA

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Naoya Shiota is a partner at Mori Hamada & Matsumoto. He received his LLB from the University of Tokyo in 2004, and his LLM from Cornell Law School in 2011. He worked at Weil, Gotshal & Manges LLP, New York, from 2011 to 2012. He is admitted to practise in Japan and the state of New York. He is fluent in both English and Japanese.

He is one of the key partners in banking practice at MHM, specializing in leveraged financings and other corporate financings. He also focuses on mergers and acquisitions, private equity and corporate law. He is closely involved with various complex transactions both in domestic and cross-border markets.

CARRIE B E SMIT

Goodmans LLP

Carrie B E Smit is a partner and head of Goodmans' tax group. Her practice focuses on corporate commercial transactions, cross-border mergers, corporate reorganisations, debt restructurings, domestic and international debt financings, international tax planning and private equity investments. She is the author of many papers on income tax matters and a frequent speaker at conferences. She was the recipient of the Best in Tax Award at the 2012 Euromoney Americas' Women in Business Law Awards. She is recognised as a leading tax lawyer by *Lexpert, Chambers Global*, *The Best Lawyers in Canada*, Euromoney, *The Legal 500 Canada* and Law Business Research's *Who's Who Legal: Canada*. She is a member of CBA and IFA. A former governor and member of the Executive Committee of the Canadian Tax Foundation, she was admitted to the Ontario Bar in 1992.

MIKHAIL TURETSKY

Latham & Watkins LLP

Mikhail Turetsky is a partner in Latham & Watkins' Moscow office. His practice focuses on finance and capital markets, and he has extensive experience advising banks and corporate clients on all aspects of transactions in Russia and the CIS. Mr Turetsky is qualified to practice law in Russia and also holds a UK LLM degree. His primary areas of expertise include debt and equity capital markets as well as a broad range of finance transactions, including project finance, structured finance and financial restructuring.

MAURUS WINZAP

Walder Wyss Ltd

Maurus Winzap is a partner in the tax team of Walder Wyss. He focuses on domestic and international tax issues, particularly in corporate reorganisations, restructurings, structured finance, acquisitions and divestments. Other areas of expertise include tax planning for collective capital investments and cross-border relocations. He lectures and publishes regularly in the field of taxation. Mr Winzap is a lecturer in international tax at the Swiss Institute of Taxation. He was the chair of the organising committee of the 69th congress of the International Fiscal Association (IFA), which took place in Switzerland in 2015. In addition, he is a member of the executive board of the Swiss Tax Law Association (Swiss branch of the IFA).

Mr Winzap was awarded his degree in law from the University of Zurich in 1997 and his Master of Law degree from the University of Virginia in 2002. He was admitted as a Swiss-certified tax expert in 2004.

Mr Winzap speaks German and English. He is registered with the Zurich Bar Registry and admitted to practise in Switzerland.

DAVID WISEMAN

Goodmans LLP

David Wiseman is a partner in the banking and finance law group at Goodmans. He represents both lenders and borrowers in a broad range of financing transactions, including cash flow lending, acquisition finance, cross-border lending, asset-based lending, project finance (with a focus on renewable energy), high yield debt and debt restructurings. He speaks and writes regularly on finance topics and is recognised as a leading banking lawyer by *Lexpert, IFLR1000* and *The Best Lawyers in Canada*, and has the highest possible rating for legal ability and ethical standards from Lexis-Nexis/Martindale-Hubbell. He was admitted to the Ontario Bar in 1997.

LUKAS WYSS

Walder Wyss Ltd

Lukas Wyss is a partner in the banking and finance team of Walder Wyss. He advises banks, insurers and other companies in connection with a broad variety of finance transactions, capital market transactions and, more generally, in regulatory, securities and corporate law matters. In finance, he focuses on corporate debt finance, leveraged finance, acquisition finance, asset finance (including real estate finance) as well as structured finance and securitisation. He advised banks in some of the largest acquisition finance transactions in 2014 and 2015.

Mr Wyss was educated at Zurich University and Lausanne University (*lic iur* 2000) and Columbia University, New York (LLM 2006, James Kent scholar). He was admitted to the Zurich Bar in 2002. Before joining Walder Wyss in 2007, he gained working experience as a district court law clerk (Meilen, ZH) and as attorney at major law firms in Zurich and New York.

Mr Wyss speaks German, English and French. He is registered with the Zurich Bar Registry and admitted to practise in Switzerland.

JASNA ZWITTER-TEHOVNIK

DLA Piper Weiss-Tessbach Rechtsanwälte GmbH

Jasna Zwitter-Tehovnik is a partner at DLA Piper and a finance and projects practitioner, qualified in four jurisdictions: Austria, New York, Slovenia and as a solicitor of the Senior Courts of England and Wales. She advises commercial and investment banks, corporates, sponsors, private equity and mezzanine financiers on a wide range of financing transactions with a focus on acquisition finance, structured finance and project finance as well as debt restructurings.

The second area of Ms Zwitter-Tehovnik's practice is infrastructure and energy projects, including private partnership transactions, (cross-border) mergers and acquisitions and privatisations, often with a focus on SEE, CEE and CIS regions. She speaks regularly at seminars and lectures. Ms Zwitter-Tehovnik is author and co-author of the *Distressed Loan Handbook* and has written several articles and commentary articles in banking and capital markets and corporate law. She is also ISDA counsel for Austria.

Appendix 2

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