ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following for their assistance throughout the preparation of this book:

ADVOKATFIRMAET BAHR AS
ALLEN & OVERY
ALTIUS
ALUKO & OYEBODE
ANJIE LAW FIRM
BREDIN PRAT
CYRIL AMARCHAND MANGALDAS
DE BRAUW BLACKSTONE WESTBROEK
GOODMANS LLP
HAMILTON ADVOKATBYRÅ
HENGELER MUELLER, PARTNERSCHAFT VON RECHTSANWÄLTEN MBB
LEE AND LI, ATTORNEYS-AT-LAW
LENZ & STAEHELIN
MORI HAMADA & MATSUMOTO
PAKSOY
PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP
PINHEIRO NETO ADVOGADOS
RAHAYU & PARTNERS IN ASSOCIATION WITH HFW
SCHIAVELLO & CO STUDIO LEGALE
SLAUGHTER AND MAY
SYCIP SALAZAR HERNANDEZ & GATMAITAN
URÍA MENÉNDEZ ABOGADOS, SLP
WOLF THEISS RECHTSANWÄLTE/ ATTORNEYS-AT-LAW
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PREFACE

This fifth edition of *The Lending and Secured Finance Review* contains contributions from leading practitioners in 25 different countries, and I would like to thank each of the contributors for taking the time to share their expertise on the developments in the corporate lending and secured finance markets in their respective jurisdictions, and on the challenges and opportunities facing market participants. I would also like to thank our publishers without whom this review would not have been possible.

I hope that the commentary that follows will serve as a useful source for practitioners and other readers.

Azadeh Nassiri
Slaughter and May
London
June 2019
Chapter 1

AUSTRIA

Leopold Höher¹

I OVERVIEW

The supply and demand for loan financing in Austria is constantly growing. This holds true despite almost all market participants engaged in the lending business – in particular credit institutions – still needing to (and will have to continue to) allocate a fair amount of resources to implement, and comply with, a variety of EU and Austrian legislation providing for a tight regulatory framework (e.g., increased equity requirements and capital buffers in the context of the particular credit institution’s risk position or profile).

Austrian lenders are very active in both the Austrian lending market and the central and eastern Europe (CEE) lending market, given that several Austrian credit institutions have a strong market presence in the CEE region. As far as financings in the CEE region are concerned, Austrian lenders provide financing to Austrian borrowers active in the CEE region and to non-Austrian borrowers located in the CEE region.

Moreover, Austrian lenders’ participation in Anglo-Saxon and German syndicated financing transactions comprises a fair amount of their overall lending activity (either with or without the involvement of an Austrian borrower or security provider).

When focusing on the Austrian law financing market, deal activity seems to be growing. In particular, infrastructure deals and public–private partnership transaction structures aiming at further modernising public and social infrastructures (e.g., glass fibre networks) are rapidly growing. Also, because of the current borrower-friendly interest rate environment, borrowers are seeking to refinance their existing debt on more favourable and commercially attractive terms.

What can also be recognised is a constantly growing interest of US- and UK-based alternative lenders and investment funds in the Austrian lending market since they were active in several significant transactions in 2018. Further, owing to the ongoing digitalisation in the financial industry, a rapidly growing demand can be seen for start-up and technology-driven financing transactions (e.g., bond issuances on blockchain technology).

A fair bulk of Austrian law-syndicated loan transactions are documented on the basis of the Loan Market Association (LMA) recommended template forms (leveraged or investment grade, as applicable) adapted to meet Austrian law requirements. However, depending on the specific circumstances of the transaction, including the size of the loans made available, the documentation standard used may be fairly shortened compared with the LMA (leveraged) template.

¹ Leopold Höher is a partner at Wolf Theiss Rechtsanwälte/Attorneys-at-Law.
Moreover, the number of non-performing loan transactions in Austria (and also the CEE region) continued to increase in 2018, and this field is expected to become even more active. Those transactions included sales of Austrian banks in the region, and of non-performing loans and leasing portfolios (e.g., of the bad bank of a former Austrian credit institution active in the CEE region).

II LEGAL AND REGULATORY DEVELOPMENTS

i Certain regulatory aspects with respect to (cross-border) lending business

Lending in Austria generally forms part of a comprehensive list of banking activities enumerated in the Austrian Banking Act. Lending may thus only be conducted on a commercial basis in Austria if the relevant loan provider has been granted an Austrian banking licence or to the extent it is validly passported into Austria under 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. Furthermore, any credit institution authorised in a Member State of the European Economic Area may perform the activities referred to in Nos. 1–15 of Annex I to the European Directive 2013/36/EU in Austria by either the establishment of a branch or by way of the freedom to provide services.

The Austrian Banking Act may also be applicable if the lending activities are conducted from a place outside Austria (i.e., if cross-border activities are carried out). However, even if not explicitly stated in the Austrian Banking Act, the existence of a lending activity presumes, at least to a certain extent, engagement in the domestic market. Whether a lending business will be considered to be carried out in Austria for the purposes of the Austrian Banking Act may be difficult to determine, as there is no law or regulation to establish the requirements that would have to be fulfilled.

Following discussions in academic literature and decisions rendered by the Austrian Supreme Court and the Austrian Supreme Court in Administrative Matters respectively, there is a non-exhaustive set of factors to be taken into consideration when assessing whether a lending activity is carried out in Austria. The risk that the result of a proposed transaction might be considered to constitute ‘lending business’ could be mitigated by avoiding any geographical connection to Austria, such as by (1) performing, to the extent possible, any negotiations in the context of the envisaged lending outside Austria; (2) executing and keeping all arrangements concerning the loans outside Austria; and (3) having all accounts relevant in the context of the lending arrangement outside Austria (ensuring, in particular, that any disbursements and repayments are made from, and to, accounts located outside Austria).

Conducting licensable activities (such as lending activities) with respect to Austrian banking law in Austria without a licence could trigger at least administrative fines and civil law sanctions; criminal sanctions may, under certain circumstances, also be imposed. Although the transaction (agreement) itself remains valid, monetary penalties may go up to €5 million (or twice of the amount of the benefit achieved). Furthermore, the law provides that whoever carries out the lending activities unlicensed shall not be entitled to any

2 The Capital Requirements Regulation (CRR).
compensation connected with such activities (e.g., interest, commissions, fees); sureties and guarantees granted in connection therewith may be ineffective. Additionally, a civil lawsuit for unfair competition by competitors could be expected.

Given the increased appetite and presence of funds in the Austrian lending market, regulatory exemptions for the respective regulated activities become more and more important and are a key structuring element of a lending transaction.

ii  Basel III implementation

As far as the Basel III framework is concerned, this has been implemented in Austria by the CRR and the transposition of the Capital Requirements Directive IV into the Austrian Banking Act, both applicable since 1 January 2014.

Furthermore, several directly applicable Commission-delegated regulations, based on regulatory technical standards drafted by the European Banking Authority, complement this legislative package.

The aim of this extensive reform is to strengthen the EU banking sector by introducing higher capital requirements in terms of quality and quantity, new liquidity requirements, improved risk management and governance, and strengthened banks’ transparency and disclosure.

iii  Intensification of know your customer checks

The core part of the Financial Market Anti-Money Laundering Act (implementing Directive 2015/849 (EU) of the European Parliament and the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing (AMLD IV)) is applicable as of 1 January 2017. The Financial Market Anti-Money Laundering Act applies, among others, to credit institutions and financial institutions pursuant to the Austrian Banking Act as well as CRR institutions pursuant to Section 9 of the Austrian Banking Act, and has a significant impact on, inter alia, the know your customer checks to be conducted by the respective institutions in relation to their customers. Each such institution is obliged to take appropriate steps to identify, assess and mitigate the risks of money laundering and terrorist financing, taking into account risk factors, including those relating to their customers, geographic areas, products, services, transactions or delivery channels, and thereby preventing the use of the EU financial system for the purposes of money laundering and terrorist financing.

iv  Introduction of an Austrian Beneficial Ownership Register

The AMLD IV requires Member States to establish a central register on the beneficial ownership of corporate and other legal entities incorporated within each Member State’s territory. The Austrian Beneficial Owner Register Act (implementing Articles 30 and 31 of the AMLD IV) provides that as of 1 June 2018 Austrian entities (with some exceptions) shall register their ultimate beneficial owners (UBOs) in the Austrian Beneficial Owner Register.

Austrian entities thereby have to disclose, inter alia, name, residence, birthday and citizenship of their UBO. A UBO by definition is a natural person. There are several routes to establish one or more UBO (e.g., based on direct or indirect ownership, or control over the Austrian entity), such as a natural person holding more than 25 per cent of the capital in the Austrian entity. If no UBO can be identified, the senior managing official (e.g., the management
board) of the Austrian entity must be registered. Currently, this register is not officially accessible. However, third parties can inspect the register when proving a legitimate interest. Furthermore, various authorities and legal representatives are entitled to inspect.

### III TAX CONSIDERATIONS

#### i Austrian withholding tax

Domestic income from the granting of capital (capital investment) is generally subject to a withholding tax of 25 per cent or 27.5 per cent under specific circumstances, unless an exemption applies. In a typical loan or credit transaction involving a (domestic or foreign) corporate entity as a lender and an Austrian borrower or an Austrian branch of a foreign borrower, no such withholding tax applies. This is because interest from private loans and other non-securitised receivables, which are not based on a bank deposit (or similar banking transaction), is not subject to withholding tax. Furthermore, interest received by a corporate entity that has neither its seat nor its place of management in Austria is not subject to tax in Austria.

In a typical loan or credit transaction involving a (domestic or foreign) corporate entity as a lender and an Austrian borrower or an Austrian branch of a foreign borrower, there are currently no limitations on the deduction of interest. In particular, Austria has no interest barrier rules. Interest paid to unrelated parties is, therefore, currently fully deductible by the borrower.

However, the Anti Tax Avoidance Directive (ATAD) (Directive EU 2016/1164) required EU Member States to implement an interest limitation rule into their domestic laws by 31 December 2018. Still, by way of derogation, Member States, which, as of 8 August 2016, have national targeted rules for preventing base erosion and profit shifting that are equally effective to the interest limitation rule set out in the ATAD, may delay the implementation of the interest limitation rule until 1 January 2024 at the latest. In the wake of the Organisation for Economic Co-operation and Development's first steps against BEPS, Austria implemented a non-deductibility provision for interest paid to related companies if the interest is subject to low or no taxation. The Austrian Ministry of Finance considers this existing provision as equally effective to the interest limitation rule under the ATAD, and thus as a justification to delay implementation of the ATAD in that respect. It seems that the European Commission does not share that view: in its published list of Member States that qualify for the delayed implementation, Austria was not mentioned. This implies that, in the European Commission's view, Austria has not implemented the interest limitation rule pursuant to the ATAD. As soon as such interest limitation rule has been implemented in Austria (the timing of which is yet unclear), interest will likely be deductible only up to an amount of 30 per cent of the earnings before interest, taxes, depreciation and amortisation.

Already, if the lender is a related party of the borrower and the lender is resident in a low-tax jurisdiction, the borrower may not be allowed to fully deduct the interest under Austrian domestic law.

#### ii Austrian stamp duty

The Austrian Stamp Duty Act contains an exhaustive catalogue of legal transactions that are in principle subject to Austrian stamp duty, provided that a written document is executed and a specific nexus to Austria exists.
Though Austrian stamp duty on loan and credit agreements was abolished with effect from 1 January 2011, loan and credit agreements may still be stamp duty-sensitive if they contain or refer to other stamp-dutiable transactions. In the context of loan and credit agreements, such stamp-dutiable transactions typically encompass assignment and transfer agreements (e.g., assignments or transfers by lenders), security assignment agreements, suretyships and mortgages.

The computation of the assessment base is regulated for each type of transaction in the Austrian Stamp Duty Act and varies according to the specific conditions of the transaction involved. In general, the stamp duty is calculated as a percentage of the contract value (e.g., the consideration agreed upon or, in the case of security transactions, the secured amount). However, the exact amount of stamp duty due must be assessed in each individual case.

The Austrian Stamp Duty Act provides for certain exemptions from Austrian stamp duty; for example, an important exemption in the context of debt trading is the exemption from stamp duty for assignments between credit institutions, if the institutions satisfy certain requirements.

Furthermore, all types of transactions that serve to secure a loan or credit agreement (with the exception of bills of exchange, which may, under certain circumstances trigger Austrian stamp duty) may be exempt from Austrian stamp duty.

In the case of stamp duty-sensitive transactions, in relation to which no exemption applies, various other schemes to mitigate the risk of triggering Austrian stamp duty are available. An option to mitigate the stamp duty risk that is commonly used in financing transactions is to execute all stamp duty-sensitive documents outside Austria and also to keep these documents outside of Austria (it is recommended that stamp duty-sensitive documents also contain a stamp duty-related warning note to strengthen parties’ awareness). After execution, the original stamp duty-sensitive document and all certified copies thereof must stay outside Austria. Further, documents that refer to stamp duty-sensitive documents and the dutiable transactions (e.g., substitute documentation, notices with respect to the stamp-dutiable transaction or documents signed by either of the parties that refer to the stamp-dutiable transaction) must not be sent to or from Austria.

With respect to standard indemnities by the borrower in respect of, inter alia, stamp duty, as foreseen in the LMA-recommended template forms, the Austrian Stamp Duty Act contains specific provisions on which party is liable for stamp duty. In the case of security transactions, this will usually only be the secured party; in most other stamp-dutiable legal transactions, both parties of the legal transaction are jointly and severally liable for stamp duty triggered. Thus, Austrian tax authorities are not legally bound by agreements between the parties that deviate from the statutory provisions. However, the tax authority shall, at its discretion (and as far as this does not contradict the statutory rules), at first approach the party that shall bear any stamp duty that is triggered as agreed between the contractual parties.

### FATCA

As far as the Foreign Account Tax Compliance Act (FATCA) is concerned and how it has affected lending transactions in Austria, LMA-based loan agreements typically include standardised FATCA-related provisions as part of the section on tax gross-up and indemnities. In loan agreements between domestic parties, however, FATCA provisions are rather uncommon. From a purely Austrian tax perspective, FATCA provisions do not affect the general tax clauses.
IV CREDIT SUPPORT AND SUBORDINATION

i Security

Austrian law recognises various types of securities, and lending transactions typically involve pledges over various asset classes, such as receivables (trade receivables, intra-group receivables, insurance receivables, etc.), bank accounts, real estate and (to the extent applicable in the context of the security package) intellectual property rights.

In the context of structuring an Austrian security package, Austrian law does not recognise the establishment of security interests over a fluctuating pool of assets (i.e., no floating charge). A security may only be valid if the collateral assets as well as the secured obligations are specified, or at least specifiable.

A pledge or mortgage under Austrian law is an accessory right and will, therefore, be subject to the same legal consequences as the secured obligations, meaning that, for example, if the secured obligation is terminated or not valid, the same would apply to the pledge.

Furthermore, a pledge cannot be separated from the secured obligation, which means that it can only be held and enforced by the creditor of the secured obligation. In the context of Anglo-Saxon and German syndicated financing transactions, this is typically achieved by the use of (English or German law-governed) parallel debt concepts. As far as Austrian secured lending transactions are concerned, usually a joint-and-several-creditor structure allowing a security agent to hold the security is implemented, pursuant to which the security agent has its own entitlement to the secured claims in its own name and on its own behalf.

Because of its accessory nature, the pledge will cease by operation of Austrian law upon payment (or other discharge) of the underlying secured obligation.

For a security (in rem) to be validly established, a public act (perfection step), in addition to an agreement, is required. The steps to be undertaken to perfect the relevant security interest depend on the asset class. The necessary act of publicity for a mortgage is registration with the land register. As far as, for example, pledges over receivables are concerned, either (1) the pledgor must make a corresponding annotation in its books and accounts, or (2) the relevant third-party debtor needs to be notified. In this context, as long as a third-party debtor has not been notified accordingly, the debtor may settle its obligations towards the pledgor with debt-discharging effect by paying to the pledgor.

Since, as outlined above, the concept of a floating charge is not recognised under Austrian law, the creation and perfection of security interests over movable assets would require the delivery of the collateral assets into the custody of the security agent or a delegate of the security agent acting as custodian. As a result of this requirement and related asset disposition control mechanics that need to be complied with to stand the tests of the Austrian courts, the taking of security over inventory depends on its importance (cost–benefit analysis) in the context of the security package.

In connection with costs associated with the establishment of securities, mortgages, for example, are subject to court fees for registration of the mortgages in the relevant land registers (in principle, 1.2 per cent of the secured amount) as well as stamp duties (in principle, 1 per cent of the secured amount), unless an exemption pursuant to the Austrian Stamp Duty Act applies (see Section III).
Guarantees and other forms of credit support

Guarantees are a very commonly used instrument in terms of credit support. Abstract guarantees under Austrian law are characterised by their non-accessory nature, meaning that any obligations under the guarantee remain unaffected by any changes to the underlying (secured) obligations.

However, in that context, despite the abstract nature of a guarantee, the validity, binding effect and enforceability may be limited or otherwise affected by, among others:

a. equitable principles of general applicability of Austrian civil law (e.g., the prohibition to abuse legal rights or similar concepts); and
b. applicable insolvency, reorganisation, fraudulent conveyance, avoidance, moratorium or similar laws of general application relating to or affecting the enforcement of creditors’ rights and remedies.

Thus, although in principle no defences or objections arising out of the arrangements underlying the (abstract) guarantee can be raised by a guarantor, a guarantor may, despite the abstract nature of the guarantee, raise defences and objections arising out of the guarantee agreement itself (if any). Such defences or objections may in particular concern (1) the invalidity of the guarantee agreement, (2) the issuance of an inadequate (payment) demand under the guarantee agreement or (3) the non-occurrence of the guaranteed event.

In terms of Austrian stamp duty considerations, though suretyships in principle would be within the catalogue of transactions that are subject to Austrian stamp duty, abstract guarantees, if structured carefully, should not trigger Austrian stamp duty as guarantee agreements are not within the scope of legal transactions enumerated in the Austrian Stamp Duty Act. In this respect, the Austrian tax authorities will only treat an agreement as a guarantee for stamp duty purposes if certain prerequisites are met (e.g., if the guarantor agrees to make unconditionally, without recourse to the validity or existence of the secured obligations, any such payment under the guarantee as the counterparty may demand and to waive any objections thereto). Moreover, according to a recent decision by the Austrian Supreme Court, a ‘guarantee’ securing the due performance of a debtor’s payment obligations was qualified as a surety upon first demand for civil law purposes since, pursuant to that decision, the court held that the accessory nature is not entirely eliminated given the guarantor may be entitled to raise defences arising out of the underlying (guaranteed) obligations.

Other instruments of credit support used occasionally in the context of Austrian secured lending transactions are bills of exchange and letters of comfort (which may, depending on the letter’s nature, qualify as either a strong or soft letter of comfort).

Priorities and subordination

As far as the ranking of (in rem) security interests is concerned, generally under Austrian law, the first come, first served principle applies, meaning that the timing of performance of the relevant perfection step is decisive for the ranking between competing security interests, with the earlier security interest being senior in rank to the later security interest.

Since Austrian law security (other than, for example, real estate) is not registered with any public registers but perfection of certain collateral assets is achieved via, for example, notices to third-party debtors, lenders have to rely on there being no encumbrance or negative pledge representations and undertakings provided for by the security provider.

For limitations that may affect the validity, binding effect and enforceability of a security interest, see Section V.
Subordination is typically achieved by either structural or contractual subordination. For purposes of contractual subordination, usually either intercreditor arrangements or subordination agreements are entered into.

V LEGAL RESERVATIONS AND OPINIONS PRACTICE

Legal opinions issued in Austria in the context of lending and secured lending arrangements contain a set of various legal limitations and qualifications that are typically also seen in other jurisdictions, as well as limitations reflecting various Austrian law specifics. The key topics addressed in the limitations section usually comprise the following.

i General effects of insolvency proceedings

Any opinion statements rendered are subject to all limitations arising from the laws relating to insolvency, bankruptcy, liquidation, receivership, moratorium and reorganisation, including certain periods before the institution of the proceedings for which a transaction may be contested, and other laws affecting the rights of creditors (including secured creditors) generally, including the principle of equitable subordination. In particular:

a during the six months after the opening of an insolvency proceeding against an Austrian entity, agreements may not be terminated except for good cause if the exercise of such rights would endanger the carrying on of the insolvent's business by the receiver and provided the restriction does not constitute severe personal or economic disadvantages to a particular creditor;

b contractual stipulations providing for the right to withdraw from or cancel an agreement, or for an automatic termination in the event of opening of an insolvency proceeding against an Austrian entity, are not enforceable, if this was the only reason for withdrawing, cancellation or termination of an agreement; and

c security instruments may not be enforceable for six months from the opening of insolvency proceedings if enforcement would jeopardise the continuation of the Austrian entity's business unless, among other things, enforcement is inevitable to prevent the creditor from incurring severe personal or economic damage.

As far as clawback regimes are concerned, pursuant to Austrian law, transactions may be subject to an avoidance claim. General requirements for avoidance are that the challenged legal act took place within a certain 'suspect period' prior to the commencement of insolvency proceedings, the challenged legal action caused a discrimination of the other creditors and the effect of a successful avoidance claim would be to increase the bankrupt's estate. Grounds for avoidance include, among others, intentional discrimination of other creditors, avoidance due to squandering of assets, avoidance due to preferential treatment and avoidance due to knowledge of insolvency.

Further, any power of attorney – even if granted irrevocably – will automatically terminate upon the opening of insolvency proceedings over the relevant entity’s assets.

ii Austrian capital maintenance rules

A rather strict system of protection of capital of companies against undue distribution to its shareholders applies to Austrian corporations and partnerships whose general partners consists merely of corporations. The concept is based on the principle that the entire set of assets of a company should be protected on behalf of the company and the company’s
creditors. This goal is reached by a set of capital maintenance rules, restricting the possibility of any direct or indirect distribution to shareholders or their affiliates. The most important exception is the right of the shareholders to receive dividend payments that are restricted to the amount of net profits as shown in the approved annual financial statement and not excluded from distribution by law or the articles of association.

Following these aims, a business transaction that provides for any value transfer to a shareholder or a shareholder’s affiliates must be concluded on arm’s-length terms supported by adequate consideration. In the absence of arm’s-length terms, the transaction constitutes an unlawful repayment of capital and thus violates Austrian capital maintenance rules. Unlawful repayment of capital may be justified by specific corporate reasons that are in the best interest of the company. When assessing whether a transaction is entered into on arm’s-length terms, not only must the specific conditions of the transaction be considered, but also whether a third party would ever enter into this specific transaction. In addition, all advantages to the company must be taken into account.

Austrian courts are interpreting this mandatory principle of Austrian law prohibiting repayment of capital from a company to its shareholders broadly. This prohibition also encompasses the granting of security interests by a company to secure a loan granted to its shareholders (upstream security) or to its shareholders’ affiliates (side-stream security) without adequate consideration.

The legal consequence of a violation of the Austrian capital maintenance rules is that the received benefit may be null and void. In that respect, limitation clauses, which are usually included in the relevant lending or security agreement, attempt to partly preserve the security interest (or guarantee) if the court concludes that the security interest (or guarantee) violates Austrian capital maintenance rules, so that the amount secured or guaranteed would be reduced to what is permissible under Austrian law. Although this approach is market standard in financing transactions, no case law is available to confirm that a limitation clause achieves its desired purpose.

Generally, Austrian capital maintenance rules are applicable in relations between the company and its shareholders. However, a loan agreement or security agreement may be null and void, and a recipient of security or a third-party lender may not be able to claim the full amount of its loan and be liable for repayment of monies received, if it either knew or by gross negligence did not know that the transaction violates Austrian capital maintenance rules. Although there is no general obligation on a lender to verify or investigate this matter, such an obligation exits if there is a strong suspicion that a transaction violates capital maintenance rules.

iii  Legal opinion practice

Legal opinions in (secured) lending transactions in Austria are usually provided by lenders’ as well as by obligors’ legal counsel. Pursuant to good market practice, legal advisers to the lenders are asked to render an enforceability opinion on the relevant financing documentation, and legal advisers to the obligors are asked to render the capacity opinion with respect to the (Austrian) obligors involved.

Legal opinions are typically addressed to the agent as well as to the finance parties that are an original party to the finance documentation as at the date on which the opinion is issued. In the context of syndicated financing transactions, opinion counsels are frequently asked to broaden the addressees to cover also persons becoming lenders during primary syndication within a predefined short period as at the execution of the relevant financing
agreement. Typically, legal opinions may be disclosed to (but not relied upon by) persons if so required by applicable law, rule or regulation; any competent judicial, governmental or supervisory body; or with the prior written consent of the opinion-issuing counsel.

iv Choice of law – submission to jurisdiction

The courts of Austria will uphold and give effect to a choice of law. A submission to courts of a jurisdiction other than Austria is legal, valid and binding, subject to the qualifications referred to in Regulation (EC) No. 593/2008 of the European Parliament and the Council of 17 June 2008 on the law applicable to contractual obligations. It is subject to the rules regarding Austrian public policy and mandatory provisions of Austrian procedural law, insolvency law and corresponding applicable European legislation (in particular, Regulation (EU) No. 1215/2012 of the European Parliament and the Council of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (the Brussels Ia Regulation)) restricting the free choice of courts. Recognition and enforcement of foreign judgments must be in line with the terms of applicable EU legislation (in particular, the Brussels Ia Regulation) and are subject to the rules of procedure set out in the Austrian Enforcement Act and other statutory regulations.

VI LOAN TRADING

In Austria, loan participations are regularly traded. Transfers of loan participations are most commonly achieved by either an assignment of rights or a transfer of rights and obligations by way of assumption of contract, in which case the whole contractual position of the transferring lender would pass to the new lender (Austrian stamp duty issues need to be considered accordingly (see Section III)).

In terms of security interests granted in favour of the initial lender, the accessory nature of Austrian law security interests (other than, for example, abstract guarantees) requires that the beneficiary of the security and the creditor of the secured claims be the same person. If security is provided in the context of syndicated facilities, the use of security agent structures allows lenders to trade their debt without the security being adversely affected. However, any replacement of the security agent may result in the legal requirement to repeat certain acts of publicity in relation to the security to ensure that the security interests remain properly perfected in accordance with Austrian law.

Additionally – funded and unfunded – sub-participations can be found frequently.

Any debt trading requires careful structuring because of regulatory requirements. In the context of debt trading, in particular, provisions encompassing banking secrecy rules need to be taken into account. Since Austrian banking secrecy and data protection rules are rather strict, these need to have already been considered at the stage of granting the loan, so that trading is not hindered by banking secrecy obligations.

VII OTHER ISSUES

Other issues that may be of particular interest for lenders in the context of (secured) Austrian financing transactions relate to Austrian companies being in financial crisis in accordance with the terms of the Austrian Act on Equity Replacements. In a financial crisis of a company, a loan granted by a qualified shareholder (i.e., a shareholder with controlling participation or with a participation of at least 25 per cent, and any person not holding a participation in
the company but having a controlling influence with regard to the company pursuant to the Act on Equity Replacements) is considered to be equity-replacing, as a consequence of which the shareholder who has granted the equity-replacing loan could not demand repayment until the borrowing company has been reorganised or restructured. Any security granted in connection with such loans may not be enforced and in an insolvency proceeding the relevant claims of the lender are subordinated.

Moreover, in the context of clawback regimes, creditors can – also outside insolvency proceedings – use rights of avoidance granted to them by the Austrian Act on Avoidance of Legal Transactions (which limits the rights of avoidance to transactions similar to the ones mentioned in the Austrian Insolvency Act (see Section V)). The claim can be filed by any creditor whose claim against the debtor has not been satisfied by the proceedings under the Austrian Enforcement Act or is not likely to be satisfied by such proceedings.

VIII OUTLOOK AND CONCLUSIONS

Though we do not see any new legal, regulatory or market developments in the near future that would have a strong impact on the Austrian law loan market, we see an ongoing digitalisation in the financial industry and, following that trend, some traditional banks increasingly embracing the new technology. Furthermore, the continuing restructuring needs of several debtors (in particular, in emerging markets where Austrian credit institutions play a very active role) have sharpened lenders’ sensibility in general. This sensibility, however, does not necessarily lead to Austrian lenders being more conservative in terms of providing new financings, but decisions whether or not a new financing is provided are carefully considered and well founded in response to the financial crisis. In general, Austrian lenders are very active and, by conducting significant lending business in Austria and the CEE region, are contributing to further stabilisation and growth in eastern Europe.
Chapter 2

BELGIUM

Yves Brosens and Britt Vanderschrick

I OVERVIEW

The volume of credit in Belgium has risen over the past few years. Despite the increased attention given to alternative finance methods, banks remain the main suppliers of credit in Belgium. The National Bank of Belgium (NBB) reported that the outstanding amount of used credit (granted to non-financial institutions) was, at the end of 2018, more than €140 billion.\(^2\) The NBB also noted that credits granted to non-financial institutions increased in 2018 while they reduced their capital, thus becoming less solvent. Operating profits, however, remained robust, boosting liquid assets.\(^3\) According to a European Central Bank (ECB) survey published in November 2017, Belgian small and medium-sized enterprises (SMEs) do not regard access to credit as their main concern.\(^4\) Interest rates continue to be low,\(^5\) which explains why many corporate borrowers have sought to refinance their outstanding credit.

In Belgium, banks often use either their own templates to document loans or, depending upon the loan size and deal structure, Loan Market Association (LMA)-style documents may be entered into.

The Belgian legislator is continually trying to improve access to credit and has adopted new laws regarding the financing of SMEs, and the security rights regime relating to movable assets.

II LEGAL AND REGULATORY DEVELOPMENTS

Banks are seeking to protect their profits against the costs of the implementation of ever-changing regulatory requirements. For this reason, Belgian loan documentation (both the banks’ own templates and the LMA-style documentation) often contain a clause on increased costs that often have the same effect as the increased-costs clause in the LMA

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1 Yves Brosens is a partner and Britt Vanderschrick is an associate at ALTIUS.
5 See footnote 2.

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templates. Such an increased-costs clause passes the costs resulting from changes in the law or regulation, including the implementation or application or compliance with Basel III or Capital Requirements Directive IV, to the borrowers.

The Belgian law, dated 21 December 2013, concerning the financing of SMEs entered into force in 2014 (the SME Financing Law) and has recently been revised by the law of 21 December 2017. This law offers certain protection to SMEs since they often have significantly less bargaining power than the truly large companies: for example, professional lenders must act reasonably and in good faith, and they must inform the SMEs adequately about the loan’s terms and conditions. The SME Financing Law also contains certain restrictions on break costs. The ambiguity regarding the SME Financing Law’s scope was rectified by the Law of 21 December 2017, stating that the SME Financing Law does not apply if one of the borrowers is not an SME or if the borrower is part of a group that, on a consolidated basis, does not qualify as an SME. This interpretation is in line with the Belgian legislator’s intention when adopting the SME Financing Law: namely protecting real SMEs that have very little bargaining power; not the SMEs that form part of a large group and can depend on the experience, know-how and bargaining power of the group when negotiating a credit agreement.

The security rights regime regarding movable assets has been modernised. The Belgian Law of 11 July 2013 on security interests over movable assets finally entered into force on 1 January 2018 (the New Belgian Pledge Law). A royal decree implementing the new law and establishing the rules regarding use of the national online pledge register was published on 14 September 2017 and entered into force at the same time as the New Belgian Pledge Law. The main feature of this New Belgian Pledge Law is that there are two methods to perfect a pledge over movable assets and make such a pledge effective against third parties: either the pledge is registered in the New Pledge Register, or the pledgor transfers possession over the pledged assets to the pledgee or a third-party pledge holder. The pledge over the business (a kind of floating charge) can no longer be granted only to entities with a European Economic Area banking licence, and registration costs of the pledge have fallen significantly.

III TAX CONSIDERATIONS

i Withholding tax

As a general rule, Belgian tax law provides a withholding tax on interest payments, but certain exemptions apply. For example, domestic law provides for an exemption from withholding tax on interest payments made by qualifying Belgian companies in favour of credit institutions (banks) located in the European Economic Area or in a state that has concluded a double tax treaty with Belgium.

ii Deductibility of interest for borrowers

Interest paid upon a borrower’s loans is tax-deductible provided that certain conditions are met. Generally, these conditions include the following: the lender must be a third party; the borrowed money must be used by the borrower to earn income from its business; and the interest may not exceed market rates (taking into account the borrower’s specific situation).

6 Articles 2 and 3 of the law of 21 December 2017, amending the law dated 21 December 2013 concerning the financing of SMEs; see the Minister of Finance’s response dated 27 January 2014 to question 0678-53.
iii Stamp and documentary taxes

Certain bank documents executed in Belgium, including loan or credit facilities agreements entered into by banking institutions or agreements creating a security interest in favour of banking institutions, are subject to a €0.15 stamp duty.

Mortgage agreements and mortgage mandates are subject to various taxes and fees. Pledge agreements over movable assets that are registered with the New Pledge Register are subject to certain registration rights (see Section IV).

iv The Foreign Account Tax Compliance Act and the Common Reporting Standard

Belgium has certain obligations regarding the exchange of information for tax purposes with other countries under the following international acts:

a a Model 1 intergovernmental agreement regarding the Foreign Account Tax Compliance Act signed by Belgium and the United States on 23 April 2014;

b the Common Reporting Standard Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information (the Organisation for Economic Co-operation and Development (OECD) Common Reporting Standard); and


The Belgian Law of 16 December 2015 regulating the communication of information regarding financial accounts, by the Belgian financial institutions and the Belgian Ministry of Finance, related to the automatic exchange of information at the international level and for tax purposes, has implemented the international acts stated above and provides for a framework for such an automatic exchange of information. Belgian financial institutions, such as banks, falling under the scope of this law will need to report and retain certain information on the reportable accounts held by them to the appropriate Belgian authority, while protecting their clients’ privacy.

IV CREDIT SUPPORT AND SUBORDINATION

i Security

Types of security interests

A security interest can be created over movable assets (tangible and intangible) and immovable assets (real estate) located in Belgium.

Real estate

A consensual security right over land, buildings or other immovable property located in Belgium is created by entering into a mortgage deed. Such a mortgage deed must be: (1) executed in Dutch, French or German before a notary; (2) registered with the tax authorities; and (3) recorded in the appropriate mortgage registers of each judicial district in which the mortgaged real estate is located (as there is no central mortgage register).

Since the costs associated with a mortgage are very high and calculated on the basis of the amount secured by the mortgage, security providers will often request limiting the amount secured by the mortgage and covering a significantly higher amount by a mortgage mandate (which is not a security interest, but only a power of attorney to create additional mortgages).
Tangible movable assets

A pledge over specific tangible or intangible movable assets is currently easy to establish in practice following the entry into force of the New Belgian Pledge Law, introducing a new title in the Belgian Civil Code.

Since 1 January 2018, a pledge over movable assets may be perfected by registering the pledge in the Pledge Register (therefore, the transfer of possession is no longer required, but it remains possible to perfect a pledge by a transfer of possession). As a result, it has become much easier to create and perfect a pledge over specific tangible or intangible movable assets. Depending on the amount secured, the registration fee for a pledge can range between €20 and €500, and between €12 and €300 to make a change to the registration in the Pledge Register.

The pledgor retains possession over the assets constituting the business and may sell the assets in the ordinary course of business so that the pledgor can keep on running its business in a normal fashion. The pledge can cover all the assets that constitute the business of the pledgor, including, among other things, the total value of the inventory, the clientele, goodwill, commercial name and signs, commercial organisation, trademarks, patents, know-how, rights under leases, furniture, commercial records, equipment and vehicles – land and buildings are excluded.

Following the entry into force of the New Belgian Pledge Law, the Business Pledge Law has been abolished. A business pledge that was validly created and perfected before this entry into force remains valid and enforceable, but will lose its rank unless it was registered in the New Pledge Register by 30 December 2018. Existing business pledge mandates will still allow establishing pledges that will be subject to the new rules introduced by the New Belgian Pledge Law.

Intangible movable assets

Shares and other financial instruments

A pledge over registered shares must be registered in the share register of the company whose shares have been pledged, and this company must be notified of the pledge or acknowledge the pledge.

A pledge over book-entry securities (e.g., shares or other financial instruments held through the Euroclear system) is perfected by transferring possession of the shares; they must be booked into a specific pledged account held by the pledgee or a person representing the pledgee.

Receivables and bank accounts

A pledge over receivables or bank accounts is only enforceable against the debtor of the pledged receivables or against the account bank once the debtor or the account bank has been notified of or has acknowledged the pledge.

Intellectual property

Perfection of a pledge over intellectual property (IP) rights will depend on the types of rights to be pledged; certain pledges must be notified to, or registered with, the relevant IP authorities or registration offices to become effective against third parties.
Security agent
Under Belgian law, certain types of security interests may only be validly created in favour of the creditors of the secured claims and cannot be held by a person acting on behalf of a fluctuating body of creditors. As a result, a Belgian security interest is often created in favour of a security agent acting in its capacity as an independent creditor of a parallel debt. A parallel debt structure is not required regarding a pledge (1) created over financial instruments, such as shares or bank accounts, as such a pledge may be created in favour of a security agent acting as a representative for one or more lenders, or (2) over other movable assets (tangible or intangible) in favour of a security agent acting as a representative for a fluctuating body of lenders.

ii Guarantees and other forms of credit support
Guarantees
There are several types of guarantees available, and parties can modify a guarantee according to their needs. For example, a guarantee can be an independent guarantee or an accessory suretyship. A guarantee can also be callable on first demand. A bank guarantee will often be callable on first demand and be independent from the underlying debt documents. A guarantee may also be unlimited or be provide for a maximum amount. Guarantees, especially upstream or side-stream guarantees, will often be limited to lower the risk that the granting of the guarantee would not be within the corporate benefit of the Belgian guarantor (see Section V).

Netting and set-offs by the borrower
Given the general rule under Belgian law that creditors should be treated equally upon a debtor’s insolvency, a person can no longer set off its debt against the receivable of another person following the insolvency of the latter. There are certain exceptions to this rule: statutory netting may occur if certain conditions are met (e.g., the receivables must be closely connected) and contractual netting will, as a rule, also survive the insolvency of one of the parties (unless the netting agreement has been entered into during a ‘hardening’ period).

The LMA clause that all payments an obligor makes must be made without set-off or counterclaim is generally deemed to be valid under Belgian law.

Negative pledge undertakings
Belgian bank lending documentation will most likely include negative pledge undertakings. Such an undertaking, however, will probably not (this is subject to debate) affect the security interest granted by an obligor breaching such a negative pledge undertaking provided that the beneficiary of the security interest was acting in good faith.

Mortgage mandates and business pledge mandates
Mortgage mandates are used to limit, or at least postpone, the costs related to a mortgage or business pledge. Such mandates are irrevocable powers of attorney to establish additional mortgages or business pledges, but neither create a security interest effective against third parties and nor give any right of priority to the banks. A mandate cannot be used to create a mortgage or a business pledge following the security provider’s bankruptcy or during a hardening period preceding the bankruptcy.
iii Priorities and subordination

Priorities
The ranking of creditors is a complex matter under Belgian law. In general, the following principles apply:

a. creditors rank equally, unless a creditor benefits from a lien or a security interest as provided for by law;

b. certain creditors, such as the creditors for certain judicial costs and the creditor for costs made to maintain or preserve assets, benefit from a super-priority lien and will always rank ahead of other creditors;

c. creditors benefiting from a specific lien (e.g., a pledge or a mortgage) will rank ahead of the creditors benefitting from a general lien (e.g., the tax and social security authorities that benefit from a statutory lien); and

d. in the case of competing security interests, the security interest that has been made effective against third parties first will often have priority.

Subordination
Subordination can be achieved contractually between creditors, through an intercreditor agreement or a subordination agreement. These agreements are often entered into between the senior creditors, the junior creditors and the debtors. The subordination of claims secured by certain security interests may require that certain formalities are complied with regarding the security interests.

V LEGAL RESERVATIONS AND OPINIONS PRACTICE

i Legal reservations
Belgian opinions are normally in line with foreign practice.

Belgian opinions contain various assumptions regarding matters of fact and foreign law. These assumptions include matters of fact relating to the conclusion of an agreement (such as no violation of public order or vitiated consent); the capacity of the Belgian companies entering into the transaction documents (e.g., regarding corporate benefit); the assets secured by a Belgian security interest (e.g., regarding ownership); financial assistance; and the genuineness and accuracy of the examined documents.

A Belgian legal opinion will typically include several qualifications, which may cover the following subjects:

a. insolvency;

b. corporate benefit and corporate purpose;

c. change of control clauses;

d. the security agent acting as trustee;

f. parallel debt;

f. financial assistance;

g. perfection of security interests;

h. ranking of security interests and other liens;

i. novation;

j. choices of law and forum;

k. recognition of foreign judgments;

l. rules of procedure; and

m. enforcement.
Corporate benefit

A commercial company subject to Belgian law must enter into a transaction with the intent of pursuing profit. This is a rule of public order. If a company enters into a transaction without the intent of pursuing profit, the company's entry into the transaction will be invalid. Whether a company intends to pursue profit is a factual matter.

In addition, the directors of a company subject to Belgian law have a duty to act in the company's corporate benefit. If a Belgian company enters into a transaction that does not fall within the company's corporate benefit, the validity of the transaction could be challenged. The rules existing under Belgian law regarding a company's corporate benefit do not contain well-defined guidelines, and the proper application of any such rules depends on the business issues affecting the company, which can only (and must) be properly assessed by its board of directors. Whether a transaction is to a company's corporate benefit is a factual matter.

Although there is very little case law on the matter, it is generally accepted among legal scholars and practitioners that the granting of a guarantee or a security interest by a Belgian company to secure the obligations of another entity may be within the guarantor or security provider's corporate benefit if the following conditions are met:

a. the guarantor or security provider itself derives a benefit from the transaction (a group benefit may be taken into account, but a mere group benefit is generally not considered to be sufficient); and

b. the risks incurred by the guarantor or security provider (e.g., the value of the encumbered assets and the amount guaranteed by the company) are proportionate to the benefit it derives from the transaction and its financial capacity.

The granting of downstream guarantees or security interests will generally (but not always) present fewer problems from a corporate benefit perspective. It would be more challenging, however, to satisfy the corporate benefit test when granting upstream or side-stream guarantees or security interests. If a Belgian subsidiary is required to guarantee or secure the indebtedness of the other group companies in the context of a group financing, the amounts guaranteed or secured by the Belgian subsidiary will often be limited to try to ensure that the security interests or the guarantee are proportionate to the Belgian subsidiary's own benefit derived from the transaction and the Belgian subsidiary's financial capacity.

Financial assistance

A Belgian company may not advance funds, grant loans or provide guarantees or security interests to facilitate the acquisition of the shares held in that Belgian company (e.g., a Belgian company may not secure the loan that is used by the borrower to finance the acquisition of the shares held in that Belgian company), unless the procedure as set out in Articles 5:152, 6:118 and 7:227 of the New Belgian Companies Code, which entered into force on 1 May 2019, is met. This ‘whitewash’ procedure is very strict and cumbersome, and not often relied upon in practice. One of the requirements is that the financial assistance must be paid out of, and cannot exceed, the distributable profits. Given these requirements, in the authors’ experience, it is often not possible to rely on this procedure.

Change-of-control clauses

The provisions of an agreement that confer or may confer rights on third parties affecting the assets and liabilities of a Belgian company incorporated as a public limited company or a partnership limited by shares, or that create a debt or an obligation of such a company
when the exercise of these rights depends on the issue of a public takeover bid on the shares of the company or on a change of the control over the company, must be approved by the company’s shareholders. The shareholders’ resolutions approving the change-of-control clauses must be filed with the relevant commercial court’s clerk’s office.

**Security agent and parallel debt**

As there is no established concept of ‘trust’ or ‘trustee’ under the present Belgian legal system, Belgian legal opinions will normally not advise on the precise nature, effect and enforceability in Belgium of the security agent’s duties, rights and powers as a trustee, or on the performance or exercise of such duties, rights and powers.

As stated in Section IV, Belgian security interests are often created in favour of a security agent acting in its capacity as an independent creditor of a parallel debt. Although a parallel debt structure is often used and generally accepted by Belgian legal scholars, legal opinions will often include a (light) qualification as to the validity of such a structure as there is no conclusive case law on this matter.

**Choice of law**

The choice of Belgian or foreign law to govern the contractual aspects of the transaction documents will generally be accepted under Belgian law, subject to certain qualifications. As a rule, these qualifications are derived from 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) or, if Rome I does not apply, the Belgian Law of 16 July 2004 regarding the code on private international law. For example, the application of foreign law may be refused if it is manifestly incompatible with Belgian laws of public policy or effect may be given to overriding mandatory Belgian law provisions.

A security interest will be subject to the laws of the jurisdiction in which the secured assets are located.

**Choice of forum**

A jurisdiction clause giving jurisdiction to the courts of Belgium or a foreign jurisdiction will generally be accepted under Belgian law, unless an exclusive ground for jurisdiction applies. The applicability of an exclusive ground for jurisdiction depends on several factors, including the subject matter of the proceedings, the chosen forum and the domicile of one of the parties.

An exclusive ground may be found in different legal acts, including the following:

- 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) (Regulation (EU) No. 1215/2012) (the domicile of the parties is not relevant for this Regulation if parties have agreed a forum);
- the Lugano Convention on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters signed at Lugano;
- Regulation (EU) No. 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings; and
- the Belgian Law of 16 July 2004 regarding the code on private international law.
Belgium

For example, parties may generally not freely choose the forum regarding proceedings related to the following:

a insolvency;
b the constitution, nullity or dissolution of companies or other legal persons, or associations of natural or legal persons;
c the rights in rem for a certain property;
d entries into public registers; or
e the registration or validity of intellectual property rights.

Recognition of foreign judgments

A final and conclusive judgment handed down by a court of competent jurisdiction outside Belgium is recognised and enforced by Belgian courts subject to and in accordance with one of the following legal acts (depending on the jurisdiction of the court that rendered the judgment):

a Regulation (EU) No. 1215/2012;
b the Lugano Convention; or
c the Belgian Law of 16 July 2004 regarding the code on private international law.

For example, a foreign judgment will not be recognised or enforced if it is manifestly contrary to public policy in Belgium.

ii Opinions practice

Belgian legal opinions covering enforceability are typically given by lenders’ legal counsel. Often, Belgian capacity legal opinions will be delivered by borrowers’ legal counsel. The authors’ have noticed that lenders’ legal counsel are increasingly requested to deliver full legal opinions covering both capacity and enforceability. An exception is being made for legal opinions delivered in the context of a US bond offering, as in that case the issuer’s Belgian legal counsel will often deliver the full legal opinion.

VI LOAN TRADING

Loans in Belgium may be traded in different ways, including through novation, assignment sub-participations, securitisation or synthetic methods.

The guarantees or security interests securing a traded loan will, as a rule, continue to exist, but in some cases certain measures must be taken. For example, if a loan is transferred through novation, liens and mortgages will only continue to exist if the parties have specifically agreed that the liens and mortgages will not cease to exist following the novation. Certain formalities may also need to be complied with such as the registration of the transfer of a mortgage with the mortgage registry or a pledge created under the New Belgian Pledge Law with the New Pledge Register.

New lenders and other secondary market purchasers may benefit from a Belgian security interest through different mechanisms. A Belgian security interest securing a parallel debt will also, indirectly, secure a new lender’s participation. The lenders will, however, have a credit or insolvency risk against the security agent that is the creditor of the parallel debt. It is also possible to create a pledge over financial instruments such as shares or bank accounts in favour of a security agent acting as a representative to one or more lenders, including new
lenders and other secondary market purchasers. Following the entry into force of the New Belgian Pledge Law, the security agent is also able to act as such a representative regarding a pledge over other movable assets (tangible or intangible).

VII  OUTLOOK AND CONCLUSIONS

Professionals dealing with secured lending in Belgium were looking forward for some time to the entry into force of the New Belgian Pledge Law, which was published in the Belgian State Gazette on 2 August 2013. The online pledge register created by this law proved to be a success. Following the usability of the New Pledge Register, action should have been undertaken to have existing business pledges registered in the New Pledge Register in the course of 2018 and at the latest by 31 December 2018.

Alternative finance methods, such as bond issues or crowdfunding, are hot topics among finance professionals, and the Belgian legislator has tried to accommodate such methods. However, bank lending is likely to remain by far the most important source of financing in Belgium in the coming years.
I  OVERVIEW

The Brazilian financial system is highly sophisticated and subject to the regulation and supervision of the Central Bank of Brazil. Brazil has faced boom-and-bust economic cycles throughout its history. In the early 2000s, Brazil benefited from rising commodity prices and political stability.

In recent years, however, the fall in commodity prices, the high level of government spending and corruption scandals led Brazil into a deep recession, and Brazilian GDP decreased 3.8 per cent in 2015 and 3.6 per cent in 2016.2

This bearish trend was reverted in 2017 and 2018, when the Brazilian GDP increased by 1 per cent per year; indices of consumer confidence – in both consumption and services – continued to improve, and the domestic interest rate decreased significantly. There was also an improvement in credit indicators, due to the combination of a decrease in portfolio risk and a greater credit supply, and this positive scenario led to an increase in lending activities; the volume of credit in the financial markets increased from 3.1 trillion reais in December 2017 to 3.257 trillion reais in December 2018,3 an increase of approximately 5 per cent. This result derives mainly from consumer credit, which rose approximately 8.6 per cent in 2018.4

II  LEGAL AND REGULATORY DEVELOPMENTS

Despite the liberalisation of banking practice in the past decades, local financial institutions still dominate the Brazilian credit market; according to the Central Bank, four local banks (Itaú Unibanco, Bradesco, Banco do Brasil and Caixa Econômica Federal) are responsible for almost 80 per cent of all credit in Brazil. Foreign-owned banks still play an important role in the financial markets, but mainly in corporate lending activities.

The Central Bank is taking several actions to foster competition among financial institutions and reduce fund costs. The major legal and regulatory development of 2018 was the regulation of credit fintechs. According to the Central Bank, this new regulatory framework seeks to foster innovation as well as to improve competitiveness and increase competition among financial institutions in the credit market.

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1 Bruno Balduccini is a partner and Roberto Panucci Filho is an associate at Pinheiro Neto Advogados.
2 Central Bank of Brazil.
3 ibid.
4 ibid.
The regulation of credit fintechs created two new types of financial institutions: the direct credit company (SCD) and the peer-to-peer lending company (SEP), which have smaller capital, regulatory and licensing requirements than traditional financial institutions.

As financial institutions, SCDs and SEPs (1) are free to charge any compensatory interest rates, without caps or limitations, being excluded from the restrictions imposed by the Brazilian usury law, (2) will have direct access to the credit risk data system of the Central Bank for credit purposes analysis and (3) may opt to have direct access to the Brazilian payment system, which allows the performance of domestic wire transfers and issuance of payment slips without the intervention of a traditional financial institution.

i  SCD

The business model of an SCD encompasses lending, financing and acquiring receivables exclusively through an electronic platform with its own financial funds. An SCD is prohibited from raising funds from the public or collecting deposits to be used in its financial activities.

The regulatory framework for SCDs is simpler than the regulatory framework applicable to banks and other financial institutions, considering that such institutions have a limited and less complex scope of activity (focusing exclusively on the extension of loans and financing, as well as on the acquisition of receivables, without leverage).

The regulation of credit fintechs allows SCDs to sell the loans they originate to (1) other financial institutions, (2) receivable investment funds invested in exclusively by qualified investors and (3) securitisation companies that distribute securitised assets solely to qualified investors. As a result, credit securitisation structures are expressly available to SCDs as a funding alternative.

ii  SEP

An SEP is a financial institution that, exclusively through an electronic platform, brings creditors and borrowers together in a peer-to-peer lending arrangement. By so doing, SEPs will intermediate the borrower–creditor relations, thus engaging in a typical financial intermediation activity.

The regulation of credit fintechs has set a more robust regulatory framework for SEPs by regulating how the financial intermediation shall take place and determining specific mechanisms for managing the credit risks in these transactions, among other issues. The regulation makes it clear that, unlike SCDs, SEPs cannot carry out lending or financing transactions using their own funds (thus, underscoring the peer-to-peer nature of such activity). Further, as a rule, neither the SEPs nor their controlling persons and affiliates can directly or indirectly hold the credit risk inherent to loan transactions carried out by the SEPs.

Only individuals or legal entities resident and domiciled in Brazil may act as borrowers in transactions intermediated by SEPs. However, creditors may comprise the following:

- individuals;
- financial institutions;
- receivables investment funds invested in exclusively by qualified investors;
- securitisation companies that distribute securitised assets solely to qualified investors; and
- non-financial legal entities.

Nevertheless, creditors other than qualified investors can lend up to 15,000 reais to one single borrower at the same SEP.
III  TAX CONSIDERATIONS

The tax treatment of loan transactions granted by local banks is more complex and substantially different to cross-border loans.

Under Brazilian tax legislation, foreign loan transactions may be subject to assessment for two main taxes: financial transaction tax (IOF) and withholding income tax (WHT). The former tax assesses foreign exchange transactions carried out for the inflow or outflow of funds to and from Brazil (with rates varying in accordance with the type of transaction that has caused the entry or exit of funds), and the latter is generally levied upon interest payable by the Brazilian party to the foreign lender.

As a rule, the IOF taxpayer in cross-border loan transactions is the Brazilian borrower. Nonetheless, the Brazilian financial institution bears the burden of collecting the IOF owed by the Brazilian borrower and paying this tax to the federal government.

For foreign loans granted to Brazilian companies, current IOF regulations determine that a 6 per cent flat rate shall apply on the inflow of funds into the country if the minimum average maturity term of the loan is equal to or shorter than 180 days. Otherwise, if a foreign loan is granted for a longer term, the 6 per cent rate upon the entry of the resources into the country is reduced to zero. If the loan enters into the country expecting to comply with the minimum average term for benefiting from the reduced IOF rate, but if for any reason the Brazilian borrower fails to meet the minimum requirement, the IOF will be considered as being due at a 6 per cent rate as from the date of the inflow of the corresponding funds, with a 20 per cent late payment penalty and interest on arrears based on the special clearance and escrow system rate also being applied.

IOF may also be levied in the event of the renegotiation of loan transactions. Brazilian foreign exchange regulation sets forth that certain types of amendments of the terms and conditions of foreign loans (such as an assignment of credit) require the execution of ‘simultaneous foreign exchange transactions’ (i.e., foreign exchange transactions that are contractually entered into as though the original loan was repaid and a new loan would be executed between the parties, even though no actual flow of funds would take place). In view of that, it is necessary to assess whether a renegotiation requires a simultaneous foreign exchange transaction and whether IOF is applicable to each part of the transaction. Within certain limits, the IOF can be changed by the Brazilian government at any time, with no need of prior approval from Congress.

In addition to IOF, the amounts paid as interest abroad are subject to WHT at a 15 per cent rate. There are two main exceptions to this rule:

a  if the beneficiary of the interest is on a jurisdiction blacklisted by the Brazilian tax regulation as a tax haven, the applicable rate will be 25 per cent; and
b  if the beneficiary of the interest is domiciled in Japan or is a branch of a Japanese bank in another jurisdiction, the applicable rate will be 12.5 per cent.

The Brazilian borrower will be held responsible for withholding and paying WHT upon the interest paid, credited, delivered, used or remitted to the lender. This tax should be discounted from the gross amounts to be paid abroad, so that if the borrower wishes to receive the actual amounts charged without reductions for taxes collected in Brazil, the tax base on the interest payments should be grossed up accordingly.
In principle, interest paid by a Brazilian borrower to a foreign lender on foreign loans is deemed to be tax-deductible for local corporate income tax purposes. Certain limitations apply to transactions entered into between related parties, such as Brazilian transfer pricing and thin capitalisation rules.

IV CREDIT SUPPORT AND SUBORDINATION

i Security

This section provides an overview of the common methods of taking securities over different types of assets in Brazil.

The following methods of credit support are available:

a in rem guarantees;
b personal guarantees;
c contract bonds;
d standby letters of credit or demand guarantees; and
e avals on promissory notes.

A fiduciary sale or assignment, mortgages and pledges are in rem guarantees, which create a privilege over the collateral in favour of the creditor, with this being the asset granted in collateral bound to the secured obligation. In such cases, creditors do not have recourse against the guarantor that provided an in rem guarantee to collect outstanding amounts after the foreclosure of the collateral, unless agreed otherwise.

The most common types of in rem guarantees are the fiduciary sale, mortgage and pledge.

A fiduciary sale is a type of security interest pursuant to which the guarantor assigns to the creditor the title of certain assets. Therefore, the guarantor continues to have possession of the assets, still being liable for the duties of an escrow agent or bailee, or a trust in relation to them. Title of the asset granted in a fiduciary sale is only given back to the guarantor when the latter has fulfilled all of its obligations under the guaranteed credit.

The fiduciary sale was introduced in Brazil in 1965, but the applicable legal framework changed in the early 2000s with the enactment of a new Civil Code and other laws. These modifications fostered the use of fiduciary sale, which is currently one of the main credit support transactions, especially because of its bankruptcy remoteness feature. Since a fiduciary sale entails the transfer of the ownership of the underlying assets to the creditors, the creditors are not exposed to the risks inherent to a guarantor’s bankruptcy. This is the main difference between a fiduciary sale and the other guarantees, which do not entail the transfer of ownership of collateral and, therefore, the creditor may be subject to bankruptcy apportionment of the guarantor.

There are two regimes applicable to fiduciary sales. On one hand, Law No. 4,728/1965 and Law No. 10,931/2004 regulate fiduciary sales within the scope of the financial and  

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capital markets, expressly allowing the fiduciary sale of fungible\(^6\) and non-fungible property and credit rights. On the other hand, the Civil Code applies to fiduciary sales that are not within the scope of the above-mentioned markets. Although the Civil Code makes no provision regarding the characteristics of the asset given as collateral in a fiduciary sale, there are precedents of the Brazilian Superior Court of Justice (STJ) narrowing the fiduciary sale under the Civil Code to non-fungible assets.\(^7\) Since foreign lenders do not qualify as financial institutions under Brazilian law, it is disputable whether a transaction with such entities would qualify as a transaction within the scope of the financial or capital markets and, therefore, it is also disputable whether these entities could benefit from a fiduciary sale of fungible assets or credit rights.

Pledges and mortgages are also commonly used as collateral in lending transactions, with pledges being applicable to movable assets and rights (e.g., machinery, inventory, vehicles, credits and shares) and mortgages to immovable assets (e.g., real estate). Different from the fiduciary sale, in pledges and mortgages the guarantor keeps the title of the collateral and, therefore, creditors may be affected by the bankruptcy of the guarantor. In addition to that, pledges and mortgages are subject to multiple liens (first, second, third priority or more); therefore, the creditor may not necessarily receive a first priority security interest with respect to a particular asset if the asset has already been encumbered in favour of another creditor. Fiduciary sale is not subject to multiple liens, since it involves a transfer of ownership to the creditor.

Brazilian law does not provide any specific restriction on taking security over all or substantially all of the assets of a debtor or guarantor. Nonetheless, it is impossible to document such a security interest in a single document, since \textit{in rem} guarantees need to be registered before different authorities depending on the type and location of the asset granted as collateral (registration with the competent authorities is a condition for perfection of such security interests).

Brazilian law forbids the creditor to keep or obtain title of collateral in the event of default (prohibition of \textit{commissoria lex}), unless the guarantor grants express consent after the maturity date of the debt or its acceleration. In view of that, if the guarantor does not grant this consent, the collateral should be sold at a public auction, the proceeds of which will be applied to the payment of the principal and interest of the debt, judicial expenses and legal fees, provided that, in the case of attachment of quotas or shares\(^8\) requested by a creditor who is not a shareholder or partner (as the case may be) of the company, the company shall be summoned for the purposes of securing the right of first refusal of its shareholders or partners.\(^9\) In any case, the balance amount (surplus), if any, shall be returned to the guarantor.

\(^6\) Regarded as commercially interchangeable with other property of the same kind.

\(^7\) Special Appeal No. 1.101.375, decided on 4 June 2013; Special Appeal No. 346.240, decided on 30 August 2002; and Special Appeal No. 97.952, decided on 6 April 2000.

\(^8\) Brazilian law presently in force does not expressly contemplate the creation of a pledge of quotas of a limited liability company. However, such a pledge of quotas has been accepted by Brazilian courts on the basis of provisions of law relating to the pledging of rights, contract rights and Law No. 6,404/76, as amended.

\(^9\) In certain cases, the transfer of shares or quotas may be subject to antitrust clearance and if the new, different, owner is a foreign entity, certain formalities before the Central Bank must be observed by the foreign entity.
ii Guarantees and other forms of credit support

Besides *in rem* guarantees, lending transactions may be secured by personal guarantees. Under Brazilian law, a personal guarantee is likely to be perceived as a surety and may be defined as a contract of a person or corporate entity by which one guarantees, in whole or in part, the performance of an obligation of someone else.

In summary, under Brazilian law:

- personal guarantees may encompass the principal amount and ancillary charges (monetary correction, interest and other fees);
- personal guarantees are granted by a guarantor and do not require the debtor’s prior consent;
- if the personal guarantee is granted by a married individual, consent of the spouse is required; and
- the guarantor has a series of benefits granted by law, which are generally waived by the parties.

Contract bonds are a type of insurance wherein the insurance company guarantees the performance of the insurance taker’s (the debtor’s) underlying obligations under the lending agreement by providing the funds for the insured party to contract another company to perform the insured obligations. Local companies or individuals domiciled in Brazil shall take out insurance coverage before local insurers for risks run in Brazil. There are a few exceptions to this rule; for example, local companies or individuals are allowed to take out insurance coverage abroad if the insurance in question is not offered by local insurance companies.

Standby letters of credit and demand guarantees are also used to guarantee loan transactions. Brazilian banks and affiliates of international banks in Brazil in general do not issue standby letters of credit or demand guarantees for local transactions. These guarantees are usually issued in connection with cross-border transactions or by financial institutions headquartered abroad.

Promissory notes are documents that represent amounts owed. Although promissory notes are not considered additional guarantees for the payment of debts, they are used to represent amounts owed under the lending transaction, and the debt stated in the promissory note may be guaranteed by a third party by means of an aval guarantee. Any legal entity or individual may issue a promissory note or grant an aval guarantee (additional requirements may be applicable if the aval guarantee is granted by individuals).

iii Priorities and subordination

In the event of bankruptcy liquidation, certain credits are excluded from bankruptcy apportionment, such as assets granted in a fiduciary sale, post-petition claims and certain labour claims. After those credits are paid, the balance of the funds received from the liquidation of the assets must be used to pay the pre-petition claims, in accordance with the following order:

- labour-related claims, limited to 150 minimum wages per creditor, and occupational accident claims;
- secured claims, up to value of the collateral;
- tax claims, except for tax fines;
- special priority claims;
- general priority claims;
- unsecured claims;
g contractual penalties and monetary penalties for breach of criminal or administrative law, including tax law; and

h subordinated claims.

Exception is made for a fiduciary sale, which is bankruptcy-remote and is, therefore, not subject to this list of priorities.

V LEGAL RESERVATIONS AND OPINIONS PRACTICE

i Legal reservations

Lending transactions and collateral may be limited by the validity of the underlying obligation, since under Brazilian law guarantees are considered an accessory duty to the underlying obligation, and the nullity of the principal obligation causes the nullity of all the accessories obligations. These limitations are not applicable to independent guarantees, such as standby letters of credit, demand guarantees and aval guarantees on promissory notes.

In addition, bankruptcy, governmental intervention, extrajudicial liquidation, insolvency, fraudulent transfer, judicial and out-of-court reorganisation procedures may impact lending transactions and guarantees (an exception is made for the independent guarantees listed above and for contract bonds).

The Brazilian Bankruptcy Law governs the insolvency proceedings involving companies and corporations, and provides three procedures to address insolvency situations, as follows:

a judicial reorganisation;

b out-of-court reorganisation or prepackaged reorganisation; and

c bankruptcy liquidation.

Judicial and prepackaged reorganisations are similar, respectively, to Chapter 11 and prepackaged arrangements under the US Bankruptcy Code. Creditors holding pre-bankruptcy claims are subject to reorganisation and generally precluded to enforce their credit rights against the debtor. Initially, claims are also not enforceable during the stay period in a judicial reorganisation proceeding. Further, if the plan of reorganisation or prepackage plan is confirmed, creditors will be bound by the plans (payment terms and corresponding rights will be governed by the relevant instrument). In a bankruptcy scenario, creditors are subject to bankruptcy apportionment of the guarantor.

ii Opinions practice

Brazilian law does not require lenders or borrowers to obtain legal opinions to enter into loan transactions, but such documents may be used to ensure that directors and officers have complied with their fiduciary duties, and to provide comfort to borrowers entering into the transaction.

Legal opinions are mainly required in loan transactions involving large amounts. Creditors generally request debtor counsel to provide legal opinions on the corporate powers of the debtor entering the transaction; observations on financial covenants with other creditors; and opinions on legality and enforceability of the loan, and the relevant collateral or guarantees. Legal opinions are especially relevant if the loan is granted to a distressed debtor, because according to the Brazilian Bankruptcy Law and in the event of bankruptcy
of the debtor, certain acts are ineffective with regard to the bankruptcy estate, whether the lender was aware of the counterparty’s economic and financial distress, and whether the debtor intended to defraud creditors.10

iii Governing law and choice of jurisdiction

Governing law

In rem guarantees of assets located in Brazil must be governed by Brazilian law. Other agreements (including credit agreements secured by in rem guarantees of assets located in Brazil) may be governed by foreign law in a contract if there is a connection between the foreign law chosen and the places where the agreement could be enforced or the place where the parties to the agreements are based. Nonetheless, discussions on the applicable law are not broadly, technically and deeply assessed before the Brazilian courts. In the event of litigation in Brazil involving an agreement governed by foreign law, Brazilian courts tend to disregard foreign law and apply Brazilian laws to the case. There is a different scenario if disputes are solved by arbitration, because arbitration law expressly allows parties to freely choose the governing law.

Foreign awards (judicial or arbitral) can be enforced in Brazil without re-examination of the merits of the case, provided the decision is as follows:

- final and unappealable; and
- previously confirmed by the STJ.

This confirmation generally takes from six to 18 months to be granted, and is available only if the decision fulfills certain formalities and if it does not violate Brazilian national sovereignty, public policy, or good morals and ethics. The STJ does not analyse the merits of the case to confirm a foreign award.

Choice of jurisdiction

Under Brazilian law, courts shall have jurisdiction (in addition to any other valid choice of jurisdiction that may have been made by virtue of contract) whenever:

- the defendant is domiciled in Brazil;
- the obligation must be performed in Brazil; or
- the fact under dispute has taken place in Brazil.

10 The following acts are ineffective with regard to the bankruptcy estate: (1) payment by the counterparty within the bankruptcy legal term (up to 90 days as of the petition of bankruptcy) of debts not yet fallen due, by any means of extinguishment of the credit right, including by discount of the relevant instrument; (2) payment made within the bankruptcy legal term of debts fallen due and enforceable, in any way other than as provided for in the relevant contract; (3) creation of a security interest, including a lien, within the bankruptcy legal term, in the case of a debt contracted previously; if the mortgaged assets are given in a subsequent mortgage, the bankruptcy estate shall receive the portion otherwise applying to the creditor of the revoked mortgage; (4) acts performed free of charge during the two years preceding the decree of bankruptcy; (5) waiver of inheritance or legacy during the two years preceding the decree of bankruptcy; (6) sale or transfer of an establishment without the express consent of or payment to all creditors existing at the time, if the debtor has not kept sufficient assets to settle his or her liabilities, unless within 30 days there is no opposition by creditors after being duly notified by a court clerk or by an officer of the Registry of Deeds and Documents; and (7) registration of in rem guarantees and of property transfer, for a consideration or free of charge, or an annotation of real property made after the decree of bankruptcy, unless there is a previous annotation thereof.
Besides the above, courts have exclusive jurisdiction in actions relating to real estate assets situated in Brazil. Parties may agree to submit disputes related to disposable rights to arbitration, but arbitration panels do not have the power to enforce a decision. The enforcement should be carried out by Brazilian courts.

VI  LOAN TRADING

Loan transactions may be structured as bilateral or syndicated loans. In both transactions, the agreement with the borrower is generally entered into only by one lender.

In syndicated loans, the lenders that provided the funding may freely trade their participation, providing notice to the syndicate leader. These transactions impact neither the borrower nor the guarantors. Nevertheless, the substitution of the syndicate leader does impact these transactions.

The sale of the transaction by the single creditor in a bilateral loan or by the syndicate leader in a syndicated loan may be made by assignment of the loan agreement, endorsement of the loan agreement or novation of the loan, depending on the terms and conditions of the original loan. In an assignment of a loan, the lender should notify the borrower of the assignment. This should not affect in rem or aval guarantees, but may cause the release of personal guarantees, contract bonds and standby letters of credit depending on the wording of the documents. In an endorsement, all the guarantees set forth in the endorsed document should survive the transaction. However, novation causes the release of all guarantees.

VII  OTHER ISSUES

i  Enforcement

In Brazil, loan agreements can be judicially enforced if the debtor fails to comply with its loan obligations. The enforcement may be made through three different types of lawsuits:

a  a summary or an enforcement procedure, where the judge may immediately order payment of the debt and the foreclosure of collateral. This lawsuit is available if:
   •  ascertainable through simple calculation, certain and undisputable; and
   •  the debt is represented by a document that qualifies as an extrajudicial enforcement instrument under Brazilian civil procedure rules;

b  an ordinary collection action, whereby an order of payment of the debt and definitive foreclosure of assets can only be carried out after a final, unappealable decision is rendered (which would take from five to 10 years to be issued, depending on the complexity of the underlying credit transaction); or

c  a monition action, which is similar to a summary procedure if the debtor does not file a defence, and which is similar to an ordinary collection action if the debtor files defence.

In view of these differences, loan transactions are usually structured to allow the lender to file a summary or an enforcement procedure to collect the debt or foreclose collateral, avoiding time-consuming ordinary collection and monition actions.

ii  Agreements using a foreign currency

As a rule, agreements and obligations enforceable in Brazil must state the amounts due in Brazilian currency. Parties may state amounts in foreign currency in certain cases, such as obligations involving foreign parties. Nonetheless, any judgment for payment of a certain
debt in foreign currency obtained in Brazilian courts should be payable in Brazilian currency in an equivalent amount on the date of actual payment. In the event of bankruptcy, all credits denominated in foreign currency shall be converted into local currency at the exchange rate prevailing in Brazil on the date of declaration of bankruptcy. In view of this, creditors must be aware that they hold an exchange rate risk in the event of bankruptcy.

### iii Registration of foreign loans before Brazilian authorities

Cross-border loan transactions with a tenor greater than 360 days must be registered before the Central Bank registry of financial transactions (ROF). Registration allows the inflow and outflow of funds relating to the registered transactions, and shall be obtained in the name of the parties to the transaction (i.e., the lender and borrower). If the guaranteed transaction is registered before the ROF, the collateral or guarantee should also be registered to allow the guarantor to remit the funds abroad.

In addition to the ROF required by the Central Bank, the Federal Revenue Office requires that foreign entities carrying out transactions be subject to enrolment with the National Registry of Legal Entities. To obtain this enrolment, the foreign entity should also be registered with the Companies Register of the Central Bank through the Central Bank data system.

### iv Limitations to lending and secured finance

Brazilian financial institutions are not allowed to grant loans, advances or guarantees; enter into derivative transactions; underwrite; or hold in their investment portfolio securities of any clients or group of affiliated clients that, in aggregate, give rise to exposure to a client or group of affiliated clients that exceeds 25 per cent of their regulatory capital.11

Government and government-controlled corporations are subject to borrowing limits and cannot grant guarantees without proper authorisation.

However, there is no limitation on borrowing by a non-regulated company or on it guaranteeing the borrowings of its subsidiaries or affiliates.

### VIII OUTLOOK AND CONCLUSIONS

The legal, regulatory and market outlook is significantly changing in 2019. During the past two decades, the Brazilian Social Democracy Party and the Worker’s Party alternated in power in the federal government. These parties, however, were affected by Operation Car Wash corruption investigations, the impeachment of Dilma Rousseff in 2016, the imprisonment of Luiz Inácio Lula da Silva (President of Brazil from 2003 to 2010), the unpopular government of Michel Temer (President of Brazil from 2016 to 2018, recently charged for corruption and money laundering) and a series of corruption accusations involving many politicians. In the

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11 For the purpose of this limit, the following public sector entities are to be considered as separate customers: (1) the government; (2) an entity controlled directly or indirectly by the government that is not financially dependent on another entity controlled directly or indirectly by the government; (3) entities controlled directly or indirectly by the government that are financially dependent among themselves; (4) a state or the federal district, jointly with all entities directly or indirectly controlled by it; and (5) a municipal district, jointly with all entities directly or indirectly controlled by it.
last quarter of 2018, Brazilians elected the candidate of the once tiny Social Liberal Party, Mr Jair Bolsonaro, as President. In addition, the Social Liberal Party became a congressional powerhouse, being the second party in number of seats in the Lower House of Congress.

In 2019, Mr Jair Bolsonaro prepared a draft bill to overhaul the Brazilian social security system, raising the minimum retirement age and cutting several privileges, which could save more than 1 trillion reais in the next 10 years. If approved by Congress, this pension reform could provide stability and boost Brazilian economy; however, failure to reform the Brazilian social security system and cut government spending would likely drive the Brazilian economy downwards to another recession.
I  OVERVIEW

i  General

The corporate lending market in Canada continued to be very active in 2018, particularly in the mergers and acquisitions area. Commercial lending by Canada’s ‘Big Six’ banks has continued to increase since the country emerged from the financial crisis. Syndicated loans are frequently used by Canadian borrowers to fund a number of activities, including acquisitions, capital expenditures, dividend recapitalisations, refinancing of existing debt and ongoing operations. Continuing low interest rates, substantial liquidity in the North American market and reasonable credit terms contributed to the attractiveness of leveraged loans for Canadian borrowers in 2018. In addition, a growth in private lending and lending to emerging industries such as the legal cannabis and technology sectors has helped the Canadian lending market. The increase in alternative lending sources and the impact of open banking will be factors to monitor in 2019.

ii  Standardised terms

The Canadian Bankers Association published the Model Credit Agreement Provisions to be used in syndicated loan transactions in Canada. The goal of the Provisions was to standardise selected provisions of loan agreements to more easily facilitate secondary market trading, and include standard provisions relating to assignments and loan trading. They are based on provisions prepared by the Loan Syndication and Trading Association, Inc. Use of the Provisions is not mandatory, but they are commonly used in syndicated loan transactions where the administration agent is a major Canadian bank.

iii  Recent Canadian deal activity

Deal volume in the Canadian mergers and acquisitions market in 2018 increased by 14 per cent from 2017, with a total of 3,415 deals announced, the highest in several years. However, from a deal value perspective the aggregate transaction value for 2018 of C$247 billion was slightly lower than the C$253 billion announced in 2017 due to fewer standout deals in 2018.
volume in 2018 peaked in the third quarter with a record 881 announced transactions. An increase in mid-market transactions was the driving force behind the surge in activity. Much of the transaction volume in 2018 came from mid-market deals with an average size of C$250 million. Sectors that saw significant activity in 2018 were energy, real estate, consumer discretionary and consumer staples. The trend of Canadian firms continuing to be more active abroad than foreigners acquiring Canadian companies continued.

iv Canadian financing sources

Canadian companies continue to finance their operations in a variety of ways. Day-to-day operations and cash management are generally financed with operating loans or lines of credit that are entered into with a company’s primary financial institution. Asset-based loans, financed on the security of a company’s working capital assets, also continue to be a frequently used source of financing for many Canadian companies, particularly in the manufacturing, distribution and retail sectors. In many cases, a significant portion of the consideration for acquisitions was funded through various types of debt obtained from a variety of sources, including 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. There has also been an increase in the number of privately financed deals in the Canadian market.

II LEGAL AND REGULATORY MATTERS

i Lender-related regulatory requirements

Canadian borrowers regularly obtain 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. Lenders that are banks or affiliated with foreign banks must obtain the necessary approvals under the Bank Act to establish a presence in Canada, and must comply with certain 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, a loan that is made by a lender located outside Canada, and that is approved, negotiated and documented outside Canada with payments being made to an entity outside Canada, should satisfy this test.

4 ibid.
5 ibid.
6 ibid.
Without connection to a bank, foreign and other lenders that are not otherwise regulated as financial institutions in Canada (e.g., insurance companies, trust companies, credit unions and private lenders) do not require any special licences or regulatory approvals to make a loan to a Canadian borrower. These 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 it is not a financial institution exempted from compliance.

Although not a Canadian regulatory issue per se, foreign lenders entering the Canadian market will also need to consider their ability to fund loans in Canadian dollars, as many Canadian borrowers require Canadian dollar borrowings.

ii  Borrower-related regulatory requirements

The activities of many Canadian 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 consent 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 require further governmental approvals, including approval of the proposed acquirer.

iii  Anti-money laundering legislation

The Proceeds of Crime (Money Laundering) and Terrorist Financing Act makes it mandatory for certain entities (including lenders) to ascertain the identity of Canadian borrowers and related parties before accepting them as clients; to 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.

iv  Basel III

In 2015, the Basel III liquidity rules started to be phased in as part of Canada’s commitment to have the rules progressively phased in by 2019. There are two minimum rules for liquidity: the liquidity coverage ratio that has a 30-day horizon, and the net stable funding ratio that has a one-year horizon. Both rules are designed to ensure adequate liquidity for banks during periods of stress. Canada’s banks remain among the best-capitalised in the world in terms of quality and quantity of capital.8

III TAX CONSIDERATIONS

i Withholding tax

Under the Income Tax Act (Canada) (the Tax Act), interest paid by a Canadian resident debtor to an arm's-length non-resident creditor will not generally be subject to the 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; computed with reference to revenue, profit, cash flow, commodity price or similar criteria; 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.

Under Canada’s ‘back-to-back’ rules, additional withholding tax may apply where an intermediary is interposed between a foreign lender and a Canadian borrower, and a higher rate of Canadian withholding tax would otherwise apply in respect of payments to the foreign lender.

ii 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:

a) borrowed money used for the purpose of earning income from a business or property; or
b) 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).

iii 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:

a) a non-resident creditor owns or has a right to acquire (or is non-arm’s length with a person who owns or has the 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
b) the debt–equity ratio of the debtor is in excess of 1.5:1.

Thin capitalisation rules may apply in a situation where financing is undertaken by a non-resident parent corporation that then on-lends the funds to its Canadian subsidiary.
iv 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 by that particular corporation and can only offset income earned by that particular corporation. Where the taxable income of the debtor corporation is insufficient 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.

v 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.

vi 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 because of FATCA withholding tax.

IV CREDIT SUPPORT AND SUBORDINATION
Secured loans are commonly used in the Canadian debt market to finance working capital, acquisitions and longer-term borrowing needs. The forms of security and quasi-security (such as 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.9

i Security

Personal property – tangible movable property

Common law provinces
Each of the common law provinces and territories in Canada has a personal property security statute (collectively, the PPSAs) that is modelled on Article 9 of the Uniform Commercial Code

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9 The common law provinces and territories in Canada are: British Columbia, Alberta, Saskatchewan, Manitoba, Ontario, New Brunswick, Nova Scotia, Prince Edward Island, Newfoundland, Nunavut, the Yukon Territories and the Northwest Territories.
in the United States. Under the PPSAs, tangible movable property consists of goods, chattel paper, documents of title and investment property. In secured financings in the Canadian market, tangible movable 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 the 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 a public notice that a debtor’s assets have been encumbered in favour of a secured creditor. The cost to file a financing statement under the various PPSAs is nominal and varies slightly with the length of the filing term. Secured parties must file under the PPSAs in every province or territory where the debtor’s assets are located if they wish to be perfected against all of those assets. Certain types of tangible personal properties such as chattel paper, instruments, money, documents of title and large goods can also be perfected by possession.

**Quebec**

Security over tangible movable property in Quebec is created by a hypothec. Registration at the Register of Movable Real Rights (RMRR) perfects the hypothec. The cost to register at the RMRR is nominal and varies slightly with the length of the filing term. 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. Though 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 any additional steps prescribed therein to establish a first-ranking claim on such assets.

**Personal property – intangible property (general)**

**Common law provinces**

Intangible personal property includes claims and receivables, contractual rights, intellectual property (IP) rights and investment property. Generally, creditors secure intangibles similarly to tangibles, by way of a security agreement and perfection by registration under

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10 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 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 those assets. In Quebec, insurance policies can be charged by a hypothec.
the PPSAs. The law of the jurisdiction where the debtor is located at the time the security interest attaches governs the validity, perfection and priority of a security interest in intangible personal property.

IP rights are governed by federal legislation, but these rights are personal property under the PPSAs and are considered intangibles. 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.

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 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. A hypothec on monetary claims (cash) is perfected by obtaining a control agreement with the financial institution holding the bank account.

Personal property – intangible property (investment property)
Financial assets such as shares and other securities are considered investment property under the PPSAs. Each of the common law provinces and territories has a Securities Transfer Act (STA) or similar legislation that is based on the 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 the STAs includes securities (uncertificated and certificated), securities entitlements, securities accounts, futures contracts and futures accounts. In secured financings, the type of investment property seen most commonly is certificated shares. 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 the 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.

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

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

12 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, deeming rules for determining a debtor’s location under the Personal Property Security Act (Ontario) became effective on 31 December 2015. These 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.
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 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\textsuperscript{13} 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 securities 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, subsurface land rights, rental income, and other profits derived from land and leasehold interests. Real estate under the QCC includes the following:

- land;
- any construction or work 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 immovable, and that ensures its utility and real rights in immovable property; and
- actions to assert such rights or to obtain possession of immovables.

Each province and territory has a real property title registration system. Secured creditors perfect interests in real property by filing a mortgage, debenture, hypothec or trust deed against the title to the debtor’s real property. Generally, registration fees for real property mortgages are nominal. However, in several provinces and territories (Alberta, Newfoundland, Northwest Territories, Yukon Territories and Nunavut) registration costs can be higher as they are calculated based on varying formulas that take into account the principal amount of the mortgage that is being registered. Lastly, there are several special statutes that govern most federally regulated facilities such as airports, prisons and major shipping ports, and these should be assessed when taking security involving these facilities.

**Security over all or substantially all of the debtor’s assets**

Security over all of a debtor’s present and after-acquired property is commonly taken by secured parties. To do so, standard practice is generally to take separate security agreements – some for personal property (e.g., general security agreements, stock pledge agreements and sometimes intellectual property security agreements) and others for real property (e.g., a hypothec or

\textsuperscript{13} For example, a clearing house, retail investment broker or bank.
debenture) – that together encumber all of the debtor’s property. Though it is possible to secure both real and personal property in single documents such as a debenture, this practice is seen less often in the Canadian market and primarily on real-estate based transactions.

ii Guarantees and other forms of credit support
Guarantees are a common feature of secured lending structures for 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.

Financial assistance
Corporate legislation has eliminated outright restrictions on financial assistance. It is permitted without restrictions of any kind in several provinces, including Ontario, Nova Scotia and Quebec. 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.14

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.

Agency concept
The concept of agency is recognised in all Canadian jurisdictions and is commonly used in secured loan structures. Agents are often used to represent lenders in a syndicate or to hold collateral on behalf of lenders.

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14 Certain provisions of the Corporations Act (Newfoundland and Labrador) restrict the ability of a corporation to provide financial assistance to related persons where the assistance would jeopardise the solvency of the corporation. In addition, Section 78 of the Corporations Act (Newfoundland and Labrador) prohibits a corporation from giving financial assistance, which may be a loan, guarantee or some other structure, to certain blacklisted persons when ‘circumstances prejudicial to the corporation exist’. The blacklist includes shareholders, directors, officers or employees of the corporation, and associates of these persons. It is a wide net that catches most entities in the same corporate organisation. Expectedly, the provisions are usually encountered in financing transactions where corporate guarantees are required or in intercompany loan situations. Although there are exceptions set out in the statute (the most commonly relied upon exceptions are the giving of assistance by a wholly owned subsidiary to its parents corporation or by a corporation to a subsidiary), when these exceptions are unavailable, a full analysis is required to determine whether the provisions are applicable and what course of action is the most appropriate to ensure that the assistance can be provided.
Until relatively 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.

**Challenging security under Canadian law**

Under Canadian law, there are several ways that a creditor or court-appointed officer could challenge security either 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 can challenge preferences and other transactions at undervalue under the federal Bankruptcy and Insolvency Act (BIA). Under Section 95 of the BIA, a trustee in bankruptcy can challenge a preference – namely a transaction with a debtor or payment made by a debtor that has the effect of preferring one creditor over another, and that was entered into within prescribed periods before insolvency proceedings in respect of the debtor were commenced. 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 gave inadequate consideration for assets, goods or services provided by the debtor within prescribed periods before insolvency proceedings in respect of the debtor were commenced. Courts can order that transfers at undervalue are void against the trustee in bankruptcy, or that the parties to the transfer pay to the debtor’s estate the difference between 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 necessary modifications) to proceedings under Canada’s other major insolvency and restructuring statute, the Companies’ Creditors Arrangement Act (CCAA).

Provincial legislation is also available to creditors or trustees to attack preferential transactions. Although there are differences among the various provincial statutes, most provinces allow a creditor to attack fraudulent conveyances and unjust preferences. 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

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15 Where a trustee refuses or neglects to take proceedings after being requested to do so by a creditor, the 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.

16 In which case, a monitor could challenge preferences and other transactions at undervalue. See Section 36.1(1) of the CCAA.

17 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 BIA or CCAA and outside such proceedings.
insolvent circumstances, unable to pay its debts or knew it was on the eve 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, or unjustly 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.

iii Priorities and subordination

Priorities

The priority of a 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 may occur in the context of a proceeding under the CCAA or the BIA. 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 court 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, and certain employee and employer pension plan contributions that are due and unpaid. Notably, a number of the Canadian federal and provincial statutory-deemed trusts and charges that can prime a lender's security outside a bankruptcy for unpaid amounts, such as vacation pay and sales taxes, will be reversed in a bankruptcy of the insolvent borrower. This might not be the case, however, where a statutory trust satisfies the general principles of trust law for creating a true trust, in which case the assets impressed with the trust would be excluded from any distribution to the insolvent borrower's secured creditors.

In a CCAA restructuring or a BIA proposal, generally, the restructuring plan or proposal 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 debtor's assets to secure, among other things, claims of, or in respect of, critical suppliers, debtor-in-possession lenders, corporate directors' indemnities, key employee retention payments 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

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18 In Callidus Capital Corp. v. Canada, 2018 SCC 47, the Supreme Court of Canada denied a taxing authority's efforts to have its deemed trust for unremitted taxes upheld as against a secured creditor who, before the insolvent debtor's bankruptcy, received proceeds from the insolvent debtor that were deemed to be held in trust for the taxing authority.

19 In a recent case, The Guarantee Company of North America v. Royal Bank of Canada, 2019 ONCA 9, the Ontario Court of Appeal held that Ontario's Construction Lien Act impresses a true trust on the funds owing to or received by a bankrupt contractor, preserving those assets from distribution to the bankrupt contractor's creditors.
Indalex Limited (Re),\(^{20}\) however, 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. Before 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 that amount would be subordinate to a court-ordered charge securing 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 existing at the time a CCAA order is made.\(^{21}\) 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.

Lenders should also be aware of a notable decision of the Supreme Court of Canada, Orphan Well Association et al v. Grant Thornton Limited et al (Redwater),\(^{22}\) which considered Alberta’s provincial regulatory regime regarding abandonment and reclamation obligations (or end-of-life obligations) with respect to abandoned oil wells.\(^{23}\) The Alberta Energy Regulator issued orders under the provincial regulatory regime requiring Redwater Energy Corporation, an insolvent oil and gas company, to fulfil its end-of-life obligations.

The question before the Supreme Court in Redwater was whether the Alberta Energy Regulator’s use of powers under Alberta’s provincial legislation to enforce compliance with end-of-life obligations could be enforced in insolvency, and whether those powers conflict with the trustee in bankruptcy’s powers under the BIA or with the order of creditor priorities prescribed by the BIA. If so, the provincial regulatory regime would be inoperative to the extent of the conflict because of the doctrine of federal paramountcy.\(^{24}\)

The majority of the Supreme Court held that, for a number of reasons, the Regulator’s use of its provincial statutory powers does not create a conflict with the BIA and therefore does not trigger the doctrine of federal paramountcy. This meant that the Alberta regime, which was binding on receivers and trustees, could be enforced against Redwater’s trustee in bankruptcy such that Redwater’s end-of-life obligations for its inactive oil and gas wells were to be satisfied from the insolvent estate, notwithstanding the impact on secured lender recovery.

\(^{20}\) 2013 SCC 6 (Indalex).

\(^{21}\) See also Grant Forest Products Inc. v. The Toronto-Dominion Bank, 2015 ONCA 570 (Grant Forest). In Grant Forest, the Ontario Court of Appeal confirmed that a judge presiding over CCAA proceedings has the discretion to permit a creditor to petition the debtor company into bankruptcy, even when the transition to bankruptcy results in a loss of the pension deemed trust and an altering of priorities in favour of a secured creditor. In addition, the Ontario Court of Appeal – although not explicitly upholding the ruling of the lower court that a wind-up deemed trust does not prevail when a wind-up is ordered after the commencement of CCAA proceedings – did distinguish the facts from the Indalex case (the wind-up deemed trust under consideration in Indalex arose before the CCAA proceedings commenced, whereas in Grant Forest, neither of the pension plans were wound up until after the CCAA proceedings commenced).

\(^{22}\) 2019 SCC 5.

\(^{23}\) These obligations refer generally to responsibilities for plugging and capping oil wells to prevent leaks, dismantling surface structures and restoring the surface to its previous condition.

\(^{24}\) The doctrine of federal paramountcy establishes that where there is a conflict between valid provincial and federal laws, the federal law will prevail and the provincial law will be inoperative to the extent it conflicts with the federal law.
Lenders will want to ensure they understand the applicable provincial regulatory regime, and its application in a potential insolvency, as well as ensure that lending values account for such risks where a Canadian borrower has potential environmental liabilities.

**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 that an unfair advantage was conferred on the creditor, and that the subordination is consistent with the remainder of the US Bankruptcy Code.

Although there is no equivalent legislative provision in Canada, recent decisions by Canadian courts have suggested that the doctrine of equitable subordination could potentially be adopted in certain 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*, where 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 and left its determination for a later date. Subsequently, in its decision in *US Steel Canada Inc (Re) (US Steel)*, the Ontario Court of Appeal ruled that the CCAA court does not have the jurisdiction under the CCAA to grant the remedy of equitable subordination. The Ontario Court of Appeal, however, left the door open for equitable subordination to apply in a BIA context on the basis that the BIA provides the court with express jurisdiction in equity. Leave to appeal to the Supreme Court of Canada was granted in respect of the Ontario Court of Appeal’s decision in *US Steel*, however, the appeal was discontinued and the Ontario Court of Appeal decision remains the authority in Canada.

**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 (term 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

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26 *Indalex*, footnote 17, at paragraph 77.
27 2016 ONCA 662.
in US dollars 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-second lien intercreditor agreement will certainly include a contractual subordination of the second lien lender’s claim to the rights 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.

**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 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 inconsistent 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 types 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 debtholders 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 ranks in priority to the junior secured debt are also frequently the subject of much discussion.
V LEGAL RESERVATIONS AND OPINIONS PRACTICE

In syndicated lending transactions, legal opinions are generally delivered by counsel to the borrower and, where necessary, local counsel in each relevant province or territory. Such opinions typically include corporate opinions; non-contravention and no breach opinions; regulatory approval opinions; share capital opinions; enforceability opinions; and creation and registration of security opinions.

It is not uncommon for lending transactions in Canada to be financed by foreign lenders based in financial centres such as New York or London. This occurs most often when the borrower is foreign or part of a larger cross-border or international corporate structure, or where the transaction being financed is a cross-border transaction. 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 are enforceable.

i Choice of law

Generally, 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, so 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 to the extent these laws have an overriding effect. In addition, they 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, Canadian courts have the discretion to stay or decline to hear an action based on a foreign judgment. Such actions may also be impacted in Canadian 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, expropriation or penal law, nor can the foreign judgment be contrary to public policy. Finally, 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 to increase predictability and certainty in the Canadian market.

VI  LOAN TRADING

The market for syndicated loans continues to be the primary means for borrowers to access financing. Syndication continues to be the avenue used by lenders to allocate and distribute exposure to certain borrowers or industry sectors. However, unlike the US loan market, the use of secondary trading in loans is limited and there is no significant market for loan participations. Syndication or assignments of loans and lending commitment are the most common methods of transferring loan exposure in Canada. Assignment by a lender of its loan position is usually permitted, subject in some cases to the borrower’s consent or only to a permitted list of assignees, and to the general requirement that the assignment must not result in increased costs to the borrower. Because of the lack of a significant secondary market for trading loans that limits term B loan availability in Canada, many large Canadian companies have instead chosen to access the term B loan market or the second lien loan market available in the United States.

Loan participants in Canada, as in most other markets, do not have a direct contractual relationship with the borrower. Though a participant assumes the risks associated with the loan transaction in which it is participating, it has no direct interest or rights under any credit documents, including the security, if any, related to the loan. In addition to the credit risk associated with a borrower, a participant also faces the risk related to the solvency of the grantor of a participation in a loan. If the grantor of a participation files for bankruptcy, for example, a participant’s right to receive payment on its underlying loan will continue to depend upon and flow through the grantor and not the borrower. The terms of the particular participation agreement will determine the rights available to the participant in a grantor’s bankruptcy as a secured or unsecured creditor.

VII  OUTLOOK AND CONCLUSIONS

It is expected that Canadian borrowers will continue to be active in the Canadian and US debt markets. There is still an opportunity to take advantage of interest rates that continue to be low by historical standards, despite several rate increases during the past year, by securing debt financing to fund acquisitions, dividend recapitalisations and other balance sheet restructurings, and to refinance existing debt with more onerous terms. In addition, it is expected that the trend of Canadian borrowers amending (including repricing) and extending their credit facilities prior to maturity will continue given the relatively favourable pricing conditions in the Canadian debt market, particularly in light of further increases in interest rates remaining a possibility depending upon the rate of inflation.

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 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 thus initiate restructuring discussions at an early stage when more options are available to address the borrower’s financial issues.

Incremental or ‘accordion’ facilities that permit the borrower to increase the amount of term or revolver facilities available, or to incur additional indebtedness in another form are an increasingly common feature of leveraged loan facilities in Canada, and are often used to finance acquisitions. The terms for these incremental facilities are generally becoming more borrower-friendly. The borrower is usually permitted to incur a fixed amount of additional debt subject to further increases, if certain financial ratios are satisfied. Most favoured nation restrictions with respect to interest rate spreads for additional debt and other protections for existing lenders with respect to the terms of incremental debt are also continuing to weaken.

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-in, last-out mechanism under an agreement among lenders.

Another trend is the increased activity level of foreign lenders in Canada, particularly those based in the United States. The increasing level and size of cross-border transactions has created new lending opportunities for foreign lenders in Canada. Many foreign lenders are also seeking to expand their relationship with clients in their home jurisdictions to affiliates of those clients located in Canada. A number of foreign lenders have established a local presence in Canada such as a foreign bank branch, and are offering a wide variety of financial products to Canadian clients. Further, there has been an increase in the number of private or alternative lenders in the Canadian market, providing bespoke financing arrangements to address borrowers’ unique financing needs and credit challenges. The increased competition in the Canadian financial market resulting from entry of additional foreign lenders and private lenders should be beneficial to Canadian borrowers.
I OVERVIEW

The loan market in the People's Republic of China (China) grows steadily. However, growth has been slowed down under the deleverage policy by regulators. Pursuant to the statistics published by the People's Bank of China (PBOC), new loans given by financial institutions in 2018 reached 16.17 trillion yuan. Among them, almost half were provided to corporate borrowers.

Commercial banks are the main providers of corporate lending in China. Other institutions such as trust companies, securities firms and credit companies are also important players in the lending market. However, loans given by such non-bank institutions have been declined as a result of strict regulations on shadow banking.

Real estate is still the key sector that obtains loans from financial institutions, although growth has slightly declined. According to PBOC statistics, around 40 per cent of new loans granted by financial institutions in 2018 went into real estate. Individual mortgage loans accounted for around two-thirds of the total loans in the real estate sector. Loans provided to the development of social housing increased steadily with 29.5 per cent growth. Loans for commercial real estate development decreased due to macromanagement of the real estate industry.

Large banks are very active in key infrastructure and energy projects, both in China and in countries that joined the Belt and Road Initiative. Loans provided to such projects are always long-term over 10 years. Banks are becoming more and more sophisticated in structuring project finance. Several years ago, banks simply relied on the parent guarantee or the guarantee from the sponsor. Now, banks often require security over assets of, and cash flows from, the projects.

II LEGAL AND REGULATORY DEVELOPMENTS

Financial regulatory reform

In March 2018, the National People's Congress approved a reform plan (the Reform) for the institutional organisations of the State Council. According to the Reform, the regulators of the banking and insurance industries merged into the China Banking and Insurance Regulatory Commission (CBIRC). Before the Reform, the banking industry had been regulated by the China Banking Regulatory Commission (CBRC) since 2002 and the insurance industry had
been supervised by the China Insurance Regulatory Commission (CIRC) since 1998. The Reform also transferred the roles of drafting key regulations and macroprudential supervision of the CBRC and the CIRC to the PBOC.

ii Inspections and sanctions

China, as a member of the Financial Action Task Force, is devoted to fighting against money laundering. One recent development in this regard is the issuance of the Interpretation on Several Issues concerning the Application of Laws in the Handling of Criminal Cases Involving Illegal Fund Payment and Settlement Business and Illegal Foreign Exchange Trading (the Interpretation) by the Supreme People’s Court (SPC) and the Supreme People’s Procuratorate, to combat criminal activities involving underground banks, which by their nature, have largely facilitated money laundering.

Due to changes to the economic landscape in China, some people are trying to transfer their funds out of China illegally. This is a severe threat to financial stability and national security. The Interpretation was released to fight against illegal money transfer and other money laundering activities. It addresses several issues concerning the application of laws in handling criminal cases involving illegal fund payment and settlement business, and illegal foreign exchange trading.

iii Opening up the financial market

Measures of opening up the financial market were provided in the government work report of 2018 issued in March. This opening-up process sped up owing to trade war tensions with the United States. At the Boao Forum for Asia in April 2018, President Xi Jinping announced further opening-up of the Chinese financial market. Immediately after the announcement, Mr Yi Gang, the governor of the PBOC, disclosed details of the opening-up measures and a timetable. In response to Mr Yi’s timetable, 2018 witnessed several new rules issued and old rules amended. These reforms include: removal of the foreign shareholding limit in Chinese-funded banks and financial asset management companies, and the expansion of the business scope of foreign-funded banks.

iv Basel III – capital adequacy requirements

China implemented Basel III on 1 January 2013, pursuant to the Pilot Rules on Capital Management of Commercial Banks issued by the CBRC. Capital requirements in China are 11.5 per cent for systemically important financial institutions (SIFIs) and 10.5 per cent for non-SIFIs.

III TAX CONSIDERATIONS

i Stamp duty

Parties to a loan agreement executed within the territory of China shall pay stamp tax at a rate of 0.005 per cent of the loan amount. If a loan agreement is executed outside China but will be used in China (e.g, for governmental registration or court enforcement), stamp duty will also be applicable.
ii Income tax

Interests received by a lender will be subject to income tax. The tax rate for a resident lender (which is incorporated in China or considered as a permanent entity in China) is 25 per cent.

A non-resident lender will be subject to a tax rate of 10 per cent, which shall be withheld by the borrower when making payment of the interest. This income tax rate may be reduced pursuant to a tax treaty between China and the country or region of tax residence of the foreign lender. For instance, pursuant to the Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, promulgated in 2006, the income tax rate for a Hong Kong lender is reduced to 7 per cent.

iii VAT

Interest under a loan agreement is subject to value added tax (VAT) after the VAT reform in 2016. The VAT reform aimed to replace business tax by VAT in all industries, including the financial services sector. Pursuant to the Notice of the Ministry of Finance and the State Administration of Taxation on Overall Implementation of the Pilot Programme of Replacing Business Tax with Value-added Tax, which took effect on 1 May 2016, financial services, including providing a loan facility within China, are subject to VAT at a rate of 6 per cent.

iv FATCA

China implemented the Foreign Account Tax Compliance Act (FATCA) Model 2 intergovernmental agreement. China has reached agreement in substance with the United States, although the formal intergovernmental agreement has not been released or come into effect to date.

In most cross-border loan transactions involving China, FATCA provisions are inserted into the facility agreement. These provisions require that, when the borrower is obliged to make a FATCA deduction, the amount of the payment due from the borrower to the lender shall be increased to an amount that (after making any FATCA deduction) leaves an amount equal to the payment that would have been due if no FATCA deduction had been made.

v The Common Reporting Standard

To fulfil the obligations under the Convention on Mutual Administrative Assistance in Tax Matters and the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information, the government issued Administrative Measures for the Due Diligence Investigation of the Tax-related Information of Non-resident Financial Accounts, effective from 1 July 2017. A financial institution incorporated in China has the obligation to distinguish accounts of different types to understand the tax resident status of their respective account holders or relevant controllers; identify non-resident financial accounts; and collect and submit account-related information to tax authorities and financial regulators. Banks have revised their accounts documents to comply with these due diligence and reporting requirements, but so far loan agreements have not been affected.
IV CREDIT SUPPORT AND SUBORDINATION

i Security

The legal framework for taking security in China was first established in 1995 by the Security Law, supplemented by the Judicial Interpretation of the SPC on Certain Issues Concerning the Application of the Security Law. In 2007, the Property Law came into effect, which improved the security law regime by allowing more types of assets for security, and simplifying the process for perfection and enforcement of security. There are three types of securities in China:

a Mortgages: can be created on either immovable or movable properties, including land, buildings, aircraft, ships, cars, raw materials and finished products. A mortgage must be evidenced in writing. The mortgaged property remains in the mortgagor’s possession. The mortgagee enjoys priority over the mortgaged property in the event of the mortgagor’s insolvency, but ownership of the mortgaged property will not be transferred to the mortgagee.

b Pledges: can be created in respect of movable properties or rights. Rights that can be pledged are limited to proprietary rights, including bills, certificates of bonds, certificates of deposit, warehouse receipts, bills of lading, fund units, shares, proprietary rights under intellectual properties or receivables. To create a pledge, a written contract must be signed and the pledgor needs to transfer to the pledgee possession of the pledged movables or title documents representing the rights. If the rights are not evidenced by title documents but by registration at a relevant authority, such as for fund units, shares and intellectual property, the pledge must be registered at the same registration authority.

c Liens: are created by law under limited situations. The beneficiary of the lien must take possession of the property in a lawful manner, otherwise it will not be entitled to the security rights over the property.

Real estate

Security over real estate is created by way of a mortgage. Real estate that can be mortgaged refers to buildings and other fixed objects on the land; land use rights; and buildings under construction.

Chinese law distinguishes between the ownership of land and the right to use land. All land in China is either state-owned or collectively owned. Land ownership cannot be mortgaged. A land use right is granted by the state to entitle a person to the exclusive use of a piece of land for a specified purpose within a specified term. The maximum term that can be granted for the right to use a piece of land varies from 40 to 70 years.

Security interests created over the real estate shall become effective upon completion of the mortgage registration. Registration of the mortgaged real property shall be made with the real estate registration authority at or above county level.

Tangible movable properties

Security over tangible movable properties can be created by way of either a mortgage or a pledge.

Pursuant to Article 180 of the Property Law, movable property that can be mortgaged includes machinery, equipment, raw materials, semi-products and products that the mortgagor is legally entitled to dispose of. Article 181 of the Property Law further provides that by entering into a written contract an enterprise a mortgagor may create a mortgage over its existing and future acquired machinery, equipment, raw materials, semi-products...
and products. To perfect the mortgage, it shall be registered with the company registration authority. In the absence of the mortgage registration, the security interest so created cannot defend against competing claims of a bona fide third party. 

Machinery, equipment, raw materials, semi-products and products as movable properties can also be pledged. To create an effective pledge, the movable properties shall be transferred to the pledgee’s possession. Possession can be either physical or constructive. As banks will not take physical possession of movable properties, a pledge is usually created by a collateral management agreement to be entered into with a warehouse keeper.

**Shares**

Security over shares is created by way of a pledge. The perfection procedure will be different between shares of listed companies and non-listed companies. Listed companies are registered and cleared at the securities register – the China Securities Depository and Clearing Corporation Limited (CD&S). The pledge of listed shares shall therefore be registered with the CD&S. A pledge of non-listed company shares shall be registered at the company registration authority.

**Financial instruments**

Security can be created over the bill of exchange and the promissory note by way of a pledge. The Negotiable Instruments Law defines a bill of exchange as an instrument signed by the issuer to order the payer to unconditionally pay a fixed sum to the payee or the bearer of the instrument at sight or at the specified date. A promissory note is defined as an instrument signed by a bank undertaking to unconditionally pay a fixed sum to the payee or the bearer of the instrument at sight.

An endorsement with remarks of the pledge must be made on the bill of exchange or promissory note to perfect the security interest. In the absence of this endorsement, the pledge created over the bill of exchange or promissory note cannot defend against the competing claim from a bona fide third party.

**Receivables**

Security over receivables is created by way of a pledge. A receivable is defined as the right to request a payment arising out of the provision of goods, services or facilities, including the right to claim present or future monetary payment and interest thereof. Typical forms of receivables that can be pledged are as follows:

- **a** claims arising from sales, including the sale of goods, the supply of water, electricity, gas and heating, and the licence to use intellectual property;
- **b** claims arising from a lease, including that of movable assets or real properties;
- **c** claims arising from the provision of services;
- **d** toll rights arising from real properties, including highways, bridges and tunnels; and
- **e** claims arising out of loans or other credit facilities.

The Property Law authorises the PBOC to register a receivables pledge. The PBOC launched an online registration system to enable the pledgee to conduct the registration.

No security can be created over any contractual rights except for the pledge of receivables.
Intellectual property rights
Security can be created over intellectual property rights by way of a pledge. Intellectual property rights include patents, trademarks and copyright. A pledge over intellectual property rights shall be registered at the National Intellectual Property Administration.

Cash deposits
Cash is in general characterised as a special type of movable asset under Chinese law. According to the judicial interpretation issued by the SPC, cash may be delivered to the creditor as security and the creditor shall have priority in applying this cash towards the satisfaction of an obligation owed to the creditor, provided that the cash is ‘fixed’ in the form of special accounts, sealed deposits or security deposits.

An alternative practice is to create a pledge over a certificate of deposit, which is issued by the deposit-taking bank. The certificate of deposit shall be transferred to the pledgee’s possession to perfect the pledge.

Other than a pledge over a cash deposit or a certificate of deposit, no security can be created on a bank account.

Vessels
Security can be created over a vessel by way of a mortgage, even if the vessel is still under construction. Mortgage over a vessel that is in excess of 20 tons shall be registered with the vessel registration authority at the vessel’s nationality port.

Aircraft
Security can be created over a civil aircraft by way of a mortgage. The mortgage shall be registered with the Civil Aviation Administration. In the absence of registration of the mortgage, the security interest so created cannot prevail against competing claims to which a bona fide third party is entitled.

Guarantees and other forms of credit support

Guarantees
A guarantee refers to an agreement between the guarantor and the creditor that when the debtor fails to perform its obligation under the loan agreement, the guarantor will take the responsibility of repayment. There are two types of guarantees: a general guarantee and a guarantee with joint and several liability.

A general guarantee will require the beneficiary first to exhaust available remedies against the debtor, to the extent of obtaining a judgment or an arbitral award.

A guarantee with joint and several liability is not conditional on obtaining a judgment or an arbitral award against the obligor. When the obligor fails to perform his or her obligations, the beneficiary may require the guarantor to perform the obligations.

Both forms permit the guarantor to enjoy the obligor’s rights of dispute under the underlying contract. That means that they are not independent guarantees.

Independent guarantees
The SPC issued Provisions on Certain Issues involving Trials of Independent Guarantee Disputes, effective from 1 December 2016, to acknowledge the increasing use of independent guarantees by Chinese banks and other financial institutions in China-related transactions.
This is the first set of rules governing the issue, operation and enforcement of independent guarantees under Chinese law. It defines an independent guarantee as a written commitment of a bank or a non-bank financial institution to pay a specified or capped amount to a beneficiary upon a demand for payment, and the presentation of certain documents that satisfies the requirements specified in the guarantee. This follows the general principles in the Uniform Rules for Demand Guarantees (International Chamber of Commerce publication No. 758).

**Quasi-security**

Quasi-security is uncommon, although the following alternative structures have been used frequently in practice:

- **a** factoring: banks use factoring to facilitate financing certain assets or commodity-based transactions;
- **b** hire purchase: banks use hire purchase to finance leasing transactions over equipment or ships;
- **c** certain assets or commodity-based transactions: banks may use retention of title as a credit support; and
- **d** a separate negative undertaking letter: although uncommon, in some bilateral loans, banks may require a negative pledge provision in the loan agreement.

**Credit insurance**

Credit insurance is frequently used nowadays, in particular, in project finance under the Belt and Road Initiative. The China Export & Credit Insurance Corporation is the key provider of credit insurance in China and it has been very active in cross-border finance transactions.

**iii Priorities and subordination**

**Contractual subordination**

Contractual subordination of debt is possible. However, its validity is questionable because, according to a basic statutory principle, all unsecured creditors are treated equally (pari passu) on the debtor’s insolvency. It is therefore probable that during the bankruptcy proceedings courts will not uphold a contractual subordination.

**Intercreditor arrangements**

In a syndicated loan, the lenders may enter into an intercreditor agreement to govern the relationship between lenders, such as mechanisms for the provision of loans and the voting procedures for deciding key issues. However, in practice, an intercreditor agreement is uncommon in China. It is more common for the provisions governing the relationship between the lenders to be directly set out in the syndicated loan agreement.

V **LEGAL RESERVATIONS AND OPINIONS PRACTICE**

**i Legal reservations**

A legal opinion is usually qualified by various reservations. Under Chinese law, corporate benefit and financial assistance are not issues. The most common reservations in China are the following.
**Insolvency**
An enforceability opinion is subject to all applicable bankruptcy, insolvency, reorganisation or similar laws affecting creditors’ rights generally.

**Registration or perfection of security**
Certain finance documents shall be filed with the relevant government authority. For example, a loan by a Chinese borrower from a foreign lender shall be registered with the State Administration of Foreign Exchange (SAFE), and a share pledge shall be registered with the company registration authority.

**Choice of foreign law**
Pursuant to the Law on the Application of Laws to Foreign-Related Civil Relations, a party in a cross-border transaction may choose foreign law as the governing law.

**Enforcement of foreign courts’ judgments**
Except where a bilateral treaty has been signed between China and the relevant jurisdiction, a foreign court judgment will not be recognised and enforced in China unless (1) there is a reciprocity mechanism established between China and the relevant jurisdiction for mutual recognition and enforcement of court judgments; and (2) the Chinese court confirms it neither contradicts the primary principles of Chinese law nor violates sovereignty, security, or social and public interest of China.

**Limit on certain provisions**
A legal opinion will include a provision setting out which clauses of the finance documents have limits on their efficacy. For example, effectiveness of terms that seek to exclude or limit a liability or duty owed may be limited by law.

**Issues not covered by legal opinions**
A legal opinion will not cover those areas that lawyers are unfamiliar with; for example, financial and accounting matters or taxation consequences.

**ii Legal opinion practice**

**Domestic transactions**
In a purely domestic transaction or a finance deal arranged by non-bank institutions, delivering a legal opinion is uncommon. Depending on the lenders’ internal risk control, some banks may require a law firm to issue a legal opinion. For regulatory compliance purposes, a legal opinion may also be required in some transactions, such as a trust company loan using funds raised from individual clients.

In most cases, there is only one law firm engaged by the lender so the legal opinion will be issued by the lender’s counsel. For bond issue deals, the issuer will engage a law firm and a legal opinion will be issued to the issuer, whereas banks as underwriters do not engage law firms.

Legal opinions for domestic transactions are different from international practice. In addition to due incorporation of the borrower and legal validity of the transaction documents, a legal opinion may also be required to cover compliance with law by the borrower in all its business, satisfaction of legal and regulatory requirements applicable for the transaction, etc.
**Cross-border transactions**

In cross-border finance transactions, legal opinion letters are very common. A legal opinion will include sections on background, documents reviewed, assumptions, opinions, qualifications and reliance. Legal opinions are usually given by the lender’s legal counsel.

Choice of foreign law is valid and binding, and would be given effect by Chinese courts except to the extent that it would be manifestly incompatible with public policy or that the choice of law was made with the intention of evading Chinese law, which, in the absence of the stated choice of law, would have invalidated such obligations.

A foreign court judgment may be enforced in China if there is a treaty or an established reciprocity mechanism between China and the jurisdiction of the foreign court. China is a member of the New York Convention so an arbitration award will be enforceable in China.

**VI  LOAN TRADING**

Trading of bilateral loans used to be popular among banks, particularly before 2015 when there was a loan-to-deposit ratio that did not exceed 75 per cent. This ratio was repealed by an amendment to the Commercial Banking Law in 2015. Therefore, trading of bilateral loans is less common now. When trading bilateral loans, banks are required to comply with the principle of authenticity and complete transfer. Parties should not circumvent regulation by way of signing repurchase agreements, spotting buyout options or signing forward repurchase agreements. Regulators specifically focus on the transfer of credit assets between banks and trust companies to avoid regulatory restrictions.

There is no concept of novation under Chinese law. For an assignment of outstanding loans without the commitment of new loans, a notice to the obligor will be sufficient. For transfer of commitment, the transferee shall sign a new agreement with the borrower.

As the primary market of syndicated loans is yet to be promoted, it will take time to develop the secondary market of syndicated loans. Regulatory authorities together with industry associations are actively promoting the development of the syndicated loans market. The China Banking Association has set up rules and issued standard documents to facilitate trading of syndicated loans.

The transfer of non-performing loans is now vigorously promoted by Chinese authorities, which is based on China’s supply-side reform and mainly aimed at reducing the leverage ratio. There are several different methods, among which debt-to-equity swap is highly recommended. Owing to the restrictions of the Commercial Banking Law, debt-to-equity swap of credit assets must be carried out through implementing agencies, which are usually set up by a commercial bank or local government.

**VII  OTHER ISSUES**

i  **Limits on interest rate**

Limits on the lending interest rate is set up by the SPC through a judicial interpretation. The upper limit is 36 per cent per annum. Any interest exceeding the upper limit is not valid and the court will uphold borrower’s requests to refund any interest exceeding the upper limit (if it has been paid). In addition, there is an alarm rate, which is 24 per cent per annum. For interest exceeding 24 per cent but below the upper rate of 36 per cent, the court will uphold neither a lender’s claim of payment by the borrower if it has not been paid nor a borrower’s claim of refund if it has been paid.
ii Non-performing loans
As China’s economic growth slows down, non-performing loans (NPLs) continue to rise. According to the regulatory indicators released by the banking regulator, CBIRC, the balance of commercial banks’ NPLs reached 2 trillion yuan by the end of 2018, accounting for 1.89 per cent of the total loans. The CBIRC urges Chinese banks to make greater efforts to manage and dispose of their NPLs. Supportive policies have been consecutively enacted by the government in recent years so that more investors are given opportunities to participate in China’s NPLs market.

iii Fake equity investment
Fake equity investment is an innovative method of investment, which makes debt in the name of equity investment. It is typically structured by a repurchase agreement, which promises a guaranteed redemption. This makes equity investment essentially a fixed-income debt finance. Fake equity investment is commonly used by trust companies, private equity funds and insurance companies, etc., particularly in real estate and infrastructure sectors to evade regulatory restrictions. Considering the characteristics and risks of the fake equity investment, regulators have taken measures to restrict it.

iv Foreign exchange control
The yuan is not fully convertible into foreign currency at present. Payments in foreign currency from China to offshore and the receiving of foreign currency from offshore fall under the supervision of SAFE.

Foreign debt
Foreign debt means debt owed by a domestic institution to a non-resident in the form of foreign currency. Borrowing foreign debt by a Chinese company is subject to administration by the National Development and Reform Commission (NDRC) and SAFE. NDRC filing is comparatively complicated and therefore most Chinese borrowers borrow short-term loans (with a tenor less than one year), which are subject to SAFE registration only. There is a limit for borrowing foreign debt for a Chinese borrower. Currently, the limit is twice a borrower’s net assets or (for a foreign-invested company) the difference between its total investment and registered capital.

Cross-border securities and guarantees
Provision of security by a Chinese entity in favour of a foreign lender (outbound security) is subject to SAFE’s administration. SAFE appealed quota for outbound security in 2014, but a non-financial entity shall register the outbound security at SAFE within 15 business days of the security document being executed. If there is any previous outbound security that has been enforced before the offshore obligor indemnified the Chinese security provider, the Chinese entity will not be allowed to provide any new outbound security unless otherwise approved by SAFE.
VIII OUTLOOK AND CONCLUSIONS

Deleveraging and the opening-up of the financial industry are two key themes of 2018 in China’s banking sector. Owing to the efforts carried out by regulators, the overall enterprise debt ratio has been decreased so as to mitigate overall financial risks. It is expected that regulators will continue to reduce leverage ratio and monitor risks in the debt market.

As for further opening-up of the financial market, lots of the measures proposed by the Chinese government in recent years were implemented by the end of 2018. In 2019, some more measures will come into force such as the Administrative Regulations on Foreign-Invested Banks. It is also expected that more opening-up measures will be issued in relation to trust, financial leasing, automobile finance, currency brokerage and consumer finance business. These reforms will bring more diversified products to the lending market.
I OVERVIEW

Following a slight contraction in 2017, the UK and EMEA loan market recouped some its strength in 2018. However, growth was primarily in the investment grade market and driven by refinancing activity, with M&A volumes increasing only modestly and a sharp drop in leveraged activity towards the end of the year.

Many borrowers continue to achieve favourable pricing and terms, but it remains to be seen whether the current borrower-friendly conditions will be sustained through 2019. Macroeconomic and geopolitical factors (including the continuing uncertainty surrounding Brexit), rising base rates, the end of European stimulus programmes and continuing regulatory pressure on the banking sector might suggest that spreads are set to increase for borrowers of all sizes, but expectations are that these factors may yet be offset by a falling demand for bank credit in the face of steady supply.2

A mixture of participants remain active in the English-law loan market. Traditional banks still play an important and active role in the loan market, and remain dominant in the investment-grade market. In other sectors, particularly in the leveraged, real estate and infrastructure finance markets, institutional investors (CLOs, finance and insurance companies, hedge, high-yield and distressed funds, and loan mutual funds) are more prominent. The years since the global financial crisis have seen the rise of alternative credit providers such as direct lending funds, particularly in the mid-market. This has been fuelled by a variety of factors, including the pursuit of yield in a low interest rate environment, the funding gap left by constrained bank liquidity and the increasingly strict regulatory capital environment applicable to banks.

Most English-law syndicated loan transactions use the Loan Market Association (LMA) recommended forms as a starting point for negotiations. In addition to various types of facility agreements and ancillary documentation for the investment-grade market (the Investment Grade Agreements) and leveraged lending (the Leveraged Finance Documentation), the LMA collection comprises multiple templates for more specialist products, including real estate, developing markets and pre-export finance.

The LMA has done a significant amount of work on documentation over the past few years, producing a number of new templates and guidance materials and making a variety of changes to the terms of its facility agreements. Much of the LMA’s output reflects legal and regulatory developments; for example, the implementation across the European Economic

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Area (EEA) of Article 55 of the EU Bank Recovery and Resolution Directive (BRRD). It has also published guidance material on the implications of Brexit for the loan market, and on the documentary and practical implications of transitioning syndicated loans from LIBOR to risk-free rates. These topics and their impact on documentation are discussed in Section II.

II LEGAL AND REGULATORY DEVELOPMENTS

Managing the steady flow of legal and regulatory changes that have emerged in response to the financial crisis, as well as other adverse events affecting the financial sector since then, remains an ongoing challenge for loan market participants.

Some of the topics outlined below have been a feature of loan documentation discussions for some time. In some cases, sufficient consensus has emerged to enable them to be addressed in the LMA templates, leaving only points of detail to be negotiated. Where there remain diverging views, the contractual treatment must be agreed on a transaction-by-transaction basis.

The probable discontinuation of LIBOR is the development that has received the most attention from loan market participants over the past 18 months. Risk-free rates, intended to be used in place of LIBOR, have been identified for all current LIBOR currencies, including most recently, the euro. Market participants and regulators are now looking at the implications of transition to these risk-free rates across the financial markets. Loans and floating rate bonds present the greatest challenge in terms of transition arrangements. Work on overcoming these challenges has intensified this year, and there is increasing regulatory pressure to reference risk-free rates in new transactions in place of LIBOR.

The prospect of Brexit and its potential impact on the loan market continues to be monitored by loan market participants. The documentation implications of Brexit were analysed in some detail in the wake of the referendum. It remains that none of the legal risks identified have prompted widespread changes to documentation terms, but as the shape of any agreed withdrawal arrangements and (potentially) the post-Brexit relationship between the European Union and the United Kingdom becomes clearer, these issues may need to be revisited.

i Sanctions and anti-corruption laws

Increasingly aggressive enforcement action and the severity of the penalties imposed by sanctions authorities, as well as reputational concerns, have in recent years prompted lenders to seek additional and specific contractual assurances from borrowers regarding the borrower group’s compliance with all sanctions and anti-corruption laws to which both the borrower group and the lenders are subject.

Initially, borrowers were resistant. Historically, these topics were addressed as part of a lender’s pre-contract due diligence and, in terms of contractual protection, lenders simply relied on general representations and undertakings relating to the borrower group’s compliance with applicable laws. Representations and undertakings on these topics are still resisted by stronger borrowers but have become common in the English-law loan market generally over the past few years.

3 Directive 2014/59/EU.
When such specific contractual assurances on sanctions and anti-corruption laws were first proposed, lenders’ individual formulations often varied widely. The wide-ranging phrasing and uncertain limits of the representations and undertakings proposed by some lenders led to these provisions being quite heavily negotiated. The lack of consensus among lenders on the appropriate scope of contractual provisions on these topics meant that, in many transactions, diverging views within the syndicate were difficult and time-consuming to resolve.

This remains the case in some instances, but over the past few years, as lenders and borrowers have become familiar with the aspects that are likely to prompt discussion, many lenders are making efforts to produce initial drafts that anticipate the most common objections from the borrower side. For example, borrowers, concerned about their ability to comply with and monitor these provisions, often seek to limit their scope by reference to specific regimes (e.g., the US Office of Foreign Assets Control regime and the EU regime) rather than any sanctions regime anywhere in the world. Limitations by reference to materiality and knowledge qualifications, particularly in relation to compliance by directors, officers and other employees, or the indirect use of proceeds, are also often sought. There is also evidence that lenders are tailoring their proposals more carefully to the risk profile of the borrower in question. It seems possible, however, that lenders and borrowers may need to revisit sanctions provisions in both existing and new lending transactions in light of the United States’s recent reactivation of sanctions against Iran, and EU and UK countermeasures against those sanctions pursuant to the EU Blocking Regulation.

To date, the LMA has not incorporated any specific provisions relating to sanctions compliance into its English-law forms of facility agreement, although its templates for developing markets transactions (the Developing Markets Agreements) contain skeleton definitions as a starting point for the insertion of appropriate commercial terms. All of the LMA’s templates contain footnotes to the representations and undertakings clauses to remind users to consider whether express contractual protection is required. These footnotes also highlight that if representations and undertakings on this topic are agreed, the parties should consider whether amendments to those provisions should be the subject of unanimous lender consent (rather than majority lender consent), reflecting the importance that individual lenders attach to such provisions. For similar reasons, in syndicated transactions, some lenders seek to provide that a breach of the agreed sanctions provisions should enable individual lenders to determine whether they wish to be prepaid and have their commitments cancelled (instead of, or even in addition to, triggering an event of default that requires a majority lender decision to enforce the debt and exit the deal).

Representations relating to anti-corruption laws feature in some of the English-law LMA templates, for example, the Leveraged Finance Documentation and the Developing Markets Agreements. They are not included in the Investment Grade Agreements.

ii LIBOR

The Chief Executive of the UK Financial Conduct Authority (FCA) announced in July 2017 that the FCA would cease to support the production of LIBOR at the end of 2021. It was later confirmed that LIBOR panel banks had agreed to continue submitting to LIBOR until this time. Whether this means that LIBOR will cease to be produced after that date remains unclear. Current indications are that LIBOR would continue to be produced only for a limited time (if at all), and would be used only for limited purposes, for example, to run
off smaller legacy transactions. The working assumption is that most financial products that mature after 2021 and that currently reference LIBOR, including loans, will transition to risk-free rates, or a derivative thereof, over time.

An important issue for the loan market is the impact of the potential discontinuation of LIBOR on existing loan documentation. The LMA templates contain an extensive fallback rate regime and market disruption provisions, which apply if a screen rate is unavailable. The fallback rates are, however, designed to bridge temporary disruptions rather than to cater for a situation where a rate is discontinued or materially altered. As such, there are concerns that current fallback arrangements may not operate effectively in this instance. Most loan documentation will therefore need to be amended to accommodate a replacement rate.

Since 2014, the LMA templates have included an optional provision that if any screen rate is unavailable, the amendments to the agreement required to implement a substitute rate may be made with majority lender consent. This is, however, an optional provision only, which is not always included in loan agreements and in any event, will only assist if LIBOR is unavailable on screen. If amendments are desired or necessary prior to that point, the consent of all lenders would still be required.

To address those concerns, during 2018, the LMA published some updated language, developed in conjunction with the Bank of England’s Working Group on Sterling Risk-Free Reference Rates, which permits changes to a syndicated loan agreement to accommodate a successor to LIBOR in a wider range of circumstances, with majority lender consent. This language includes a number of options to acknowledge that individual lenders and borrowers may have different views on the circumstances in which a transition to a substitute rate may be agreed and the appropriate lender voting arrangements.

Lenders and borrowers may also have different views as to when it is appropriate for the loan market to transition from LIBOR. The Bank of England’s Working Group on Sterling Risk-Free Reference Rates endorsed a reformed version of SONIA as the preferred alternative to sterling LIBOR, which has been available since April 2018. In theory, it is currently possible to write a loan referencing SONIA in place of LIBOR, and SONIA-linked bonds and structured products are now seen in practice and increasingly common. SONIA also has an advantage over other risk-free rates (such as the rate chosen by the US authorities for dollars) in that is it a reformed, rather than an entirely new, rate. As such, it is traded and is better understood. However, SONIA, like other risk-free rates, is materially different from LIBOR in a number of respects. It is an overnight and backward-looking rate. A move from a forward-looking term rate such as LIBOR to a backward-looking overnight rate such as SONIA has potential implications for borrowers in terms of their ability to predict and manage cash exposures. These difficulties are not insurmountable, but do require careful consideration and material changes to systems and processes. As a result, they may not be desirable for all users, suggesting that a term rate derived from SONIA is a preferable solution for the loan market. The options for calculating such a term rate are currently being examined by the Bank of England. However, whether a term SONIA rate will be available remains uncertain. At the time of writing, the key focus of the UK-based working groups is on the appropriate conventions for referencing SONIA directly in loans. Work is also ongoing on how the economic differences between LIBOR, which takes account of bank credit risk, and SONIA, which does not, might be dealt with.

In summary, although a number of difficult issues remain to be resolved, thinking and market acceptance appears to be evolving. It is hoped that guidance on transition of the sterling loan market will become available in the near future. Similar work is ongoing in each
of the LIBOR currency countries, but each project is at a differing stage. Coordination of progress across currencies as well as across products will be key to a smooth transition, not least in the loan market where multi-currency facilities are commonplace.

iii Article 55 of the BRRD

The BRRD introduced an EEA-wide framework for the recovery and resolution of credit institutions and investment firms. Among other things, it requires Member States to confer specified resolution powers on regulators in respect of EU credit institutions, most investment firms and their groups, building on the special resolution regime put in place in the United Kingdom under the Banking Act 2009.

The United Kingdom’s obligations under the BRRD prompted the addition of a new resolution tool to the Banking Act, the power to convert and bail-in the liabilities of an institution. The bail-in powers conferred on the authorities are broad-ranging. The Banking Act makes provision for the conversion of an institution’s debt to equity and empowers the authorities to cancel or modify the terms (or the effect of the terms) of a contract under which an institution has a liability.

The ability of the Banking Act regime to interfere with a failing institution’s obligations governed by foreign law (i.e., whether it would be effective to do so) has always been in question. The BRRD, as an EU measure, addresses this problem within the EEA by providing for mutual recognition. It also seeks to solve the problem, in so far as possible, in contracts governed by the laws of non-EEA jurisdictions.

Article 55 of the BRRD seeks to make the bail-in tool effective in relation to liabilities governed by the law of a non-EEA country by requiring institutions (under threat of enforcement action by their local regulator – in the United Kingdom, a fine or censure) to include in all contracts governed by non-EEA law under which they assume a liability, a bail-in clause that acknowledges that the EEA institution party is subject to those provisions. ‘Liability’ is not defined in the EU legislation but has been construed broadly in the UK regulatory provisions, which define ‘liability’ as ‘any debt or liability to which the BRRD undertaking is subject, whether it is present or future, certain or contingent, ascertained or sounding only in damages’.

The main objective of the bail-in tool is to enable the recapitalisation of a failing institution; for example, by implementing a debt-for-equity swap. The LMA and others have raised concern with regard to the definition of ‘liabilities’ adopted by the UK regulators, as it suggests that a bail-in clause will be required in documents containing liabilities that would seem unlikely ever to be the subject of a bail-in. For example, in the context of the syndicated loan market, BRRD firms are most often party to syndicated lending documentation as lenders or in an administrative capacity, for example, as agent. Their liabilities include their obligation to provide credit and certain contingent payment obligations, under indemnities.

To facilitate compliance with Article 55 by its members subject to the BRRD, the LMA produced a form of bail-in clause for use in conjunction with loan documentation governed by the law of a non-EEA country pursuant to which a relevant institution assumes a liability. The LMA form of bail-in clause is now incorporated into most non-EEA law loan documentation, including ancillary documentation to which any lender subject to the BRRD is a party.

Following Brexit, the United Kingdom will (absent special arrangements) become a third country for the purposes of the BRRD. In anticipation, it has been suggested by
some that Article 55 clauses should also be included in English-law contracts (such as the Investment Grade Agreements) under which an EEA institution has a liability and is expected to continue beyond the United Kingdom’s withdrawal from the European Union.

Currently, there seem to be mixed views among the banking community in the EU 27 as to whether this is necessary or advisable. So far, Article 55 clauses are not being adopted in English-law lending documentation on a widespread basis. The LMA has alerted its members to this issue and further updated its standard Article 55 clause and guidance in April 2019, but has not recommended that this clause should be adopted in English-law agreements.

iv  IFRS 16 (lease accounting)

IFRS 16 was published in January 2016. It represents a major accounting change, which has had (and will continued to have) an impact on financial definitions and ratios used in loan and other finance documentation. It is mandatory for accounting periods starting on or after 1 January 2019, although it can be adopted earlier subject to conditions.

In summary, leases could be accounted for in different ways under historical rules (IAS 17). In the lessee’s accounts, finance leases were essentially treated as borrowings. The leased asset appeared on the asset side of the balance sheet and a discounted amount in respect of the obligation to pay rent appeared as a liability, as if the lessee had bought the asset and incurred debt to pay for it. Assets leased under an operating lease, in contrast, did not appear on the balance sheet.

IFRS 16 does not substantially change the IAS 17 lessor accounting regime, but it represents a major alteration in the approach to lessee accounting. Broadly, it requires all leases – including leases that are currently classified as operating leases – to be accounted for on-balance sheet.

This change has the potential to affect loan documentation in a number of ways: the balance sheet recognition of operating lease commitments will affect loan terms that reference the lessee group’s total assets; for example, asset-based financial ratios and guarantor coverage tests. EBITDA calculations will be affected owing to the additional charges to interest and depreciation on leases previously classified as operating leases. Particular attention has focused on provisions that purport to measure indebtedness. Loan market practice is to treat only finance lease obligations as borrowings, in line with the IAS 17 accounting treatment.

The potential for uncertainty means that for some time, borrowers with loan facilities extending beyond the implementation date for IFRS 16 have chosen to provide expressly that any provision that incorporates the concept of a finance lease shall be interpreted as that term is interpreted on the date the facility was entered into. Underlining the importance of this development in the loan market, the LMA templates include optional wording to this effect. With IFRS 16 now in force, it is anticipated that affected clauses and definitions will need to be adjusted to accommodate the implications of the new standard, although as yet, there remains no generally accepted approach. Adjustments, where made, are being drafted to accommodate the circumstances of the relevant borrower.

v  Brexit – documentation issues

The legal and regulatory changes that could flow from the United Kingdom’s departure from the European Union (as well as the potential commercial implications of Brexit) have been analysed in some detail.
The key legal risks examined include the following:

a the impact of Brexit on dispute resolution options;

b the use of references to the European Union and to EU legislation in lending documentation;

c the tax implications of leaving the European Union for payments under loan documentation; and

d whether an Article 55 clause should be included in English-law loan documentation (as noted above).

In general, none of these identified risks have, to date, prompted changes to documentation terms that are being adopted on a market-wide basis. The only exception is that if a clause incorporates a reference to the European Union, the parties may specify whether that term is intended to include the United Kingdom.

In relation to a number of these points, this inaction is because closer analysis has led to the conclusion that Brexit is unlikely to present an issue, at least from a UK perspective. For example, the application of the UK withholding tax regime as it affects payments under a loan agreement (discussed further in Section III) is not predicated on EU membership.

In other cases, there is consensus as to the nature of the risk, but whether the risk needs to be addressed contractually depends on the United Kingdom’s exit arrangements, which remain uncertain. For example, there is some incentive for the remaining EU Member States to agree some form of reciprocal arrangement as part of the United Kingdom’s exit negotiations to ensure their own judgments remain enforceable in the same circumstances as currently in the United Kingdom (as well as a number of legal options that the United Kingdom is preparing to take itself if no withdrawal agreement is agreed). Further, even in the absence of a negotiated solution, English judgments will remain enforceable under the local laws of most of the remaining EU Member States. Accordingly, in most instances the general conclusion is that current market practice should be maintained.

This is reflected in the LMA’s response to adjusting documentation generally. Although it has published some helpful guidance material and some slot-in ‘designated entity’ language (see below), it has not yet recommended any changes to its template documentation. As a result, the need for and extent of any Brexit-related adjustments is likely to require attention in most loan transactions until there is greater certainty with regard to the shape of the United Kingdom’s withdrawal from, and future relationship with, the European Union (even if the conclusion, as in most cases currently, continues to be that no action is required).

### vi Brexit – loss of passporting rights and ‘designated entities’

The main implication of Brexit for most regulated financial institutions, in relation to loans and other products, is whether they will be able to continue to offer those products after Brexit if the EU passports on which the provision of those products currently relies are withdrawn. Commercial lending is not a regulated activity in the United Kingdom; however, that is not the case in all EU countries, so there will be transactions where a lender currently holds its commitment or participation, or both, through its UK entity and lends to borrowers in relevant EU countries in reliance on its passporting rights under the EU Capital Requirements regime. If those rights come to an end (and local regulation in the relevant country requires the lender to be locally authorised to continue to participate in the relevant facility), the lender may need to transfer its commitments to an appropriately authorised local entity or exit the deal. It is now clear that passporting rights will cease after Brexit (or
on the expiry of any agreed transition period). There is, however, no clear view as to what might replace the current regime, except that it is likely to be based on the European Union’s existing ‘equivalence’ regime for third countries.

Current LMA terms provide lenders with a certain amount of flexibility in this regard: transfers and assignments to affiliates do not require borrower consent, and lenders are entitled to be prepaid and their commitments cancelled if it becomes unlawful for them to continue to participate in the facility. Prompted by these concerns, in April 2017, the LMA published an additional slot-in mechanism that permits lenders to designate locally authorised affiliates to participate in particular loans under a syndicated facility. This ‘designated entity’ language enables lenders to have appropriately authorised local affiliates ready to step in to take on particular loans, without the need (subject to applicable regulatory requirements) to pre-allocate capital in the relevant countries or undertake a full transfer process.

In addition, in September 2018, the LMA produced an updated version of its note on the implications of Brexit for LMA facility documentation. This includes an expanded summary of possible adjustments to documentation aimed at mitigating against a loss of passporting rights. Given the ongoing uncertainty, the LMA does not currently intend to introduce any of these potential modifications into the LMA template documentation.

III TAX CONSIDERATIONS

i UK withholding tax
Payments of interest by a UK borrower or UK branch of a foreign borrower, or that otherwise have a UK source and that are made on a loan that is capable of being outstanding for more than one year, are subject to UK withholding tax, currently at a rate of 20 per cent, unless an exemption applies. The UK tax regime provides for lenders to receive interest payments free of UK withholding tax if they are UK banks or UK branches of overseas banks that bring that interest into account for UK corporation tax purposes, UK tax-paying companies or partnerships, or UK building societies.

Lenders that are tax-resident outside the United Kingdom may also receive interest payments free of withholding tax if they qualify under a double tax treaty with the United Kingdom (‘Treaty Lenders’, in LMA terminology). As well as satisfying the conditions in the applicable treaty, directions must be obtained from Her Majesty’s Revenue and Customs (HMRC) stating that the borrower can pay interest without deducting tax. The introduction, in September 2010, of HMRC’s Double Taxation Treaty Passport Scheme (DTTPS) has, where applicable, improved the time frames within which such directions can be obtained, but there remains a greater risk of withholding tax arising in the case of Treaty Lenders than in the case of UK lenders (unless the borrower is a strong credit and has been able to limit its gross-up obligation such that it does not apply if clearance is not obtained).

The scope of the DTTPS has since been extended such that for loans entered into on or after 6 April 2017 the parties no longer need to be corporates. Assuming the relevant conditions are satisfied, it can now be used if the UK borrower is an individual, a partnership or a charity or if a Treaty Lender is a sovereign wealth fund, pension fund, partnership or other tax-transparent entity, provided in the last case that the beneficial owners of the interest are entitled to the same treaty benefits under the same treaty.

The treatment of UK withholding tax risk in loan documentation is well settled and reflected in the LMA’s English-law templates. In summary, the borrower is obliged to gross up the amount payable to the lenders should the borrower be required to deduct tax from
such payments, provided the recipient lender was a ‘qualifying lender’ on the date of the agreement. The effect is to limit the circumstances in which the borrower might become obliged to deduct tax and gross up any payment to a lender to a change in law that results in a ‘day-1 qualifying lender’ ceasing to be exempt from UK withholding tax.

ii Stamp and documentary taxes
No UK stamp or documentary taxes generally apply to loan, security or loan trading documentation where a security trustee structure is used (assuming the loan is not considered to have equity-like characteristics).

iii FATCA
The conclusion of intergovernmental agreements (IGAs) between the United States and a number of countries, including the United Kingdom and most of Europe, has had the effect of largely eliminating the risk of FATCA withholding for financial institutions within the scope of those agreements. As a result, lenders in jurisdictions covered by an IGA have become more comfortable with FATCA, and practice for addressing the withholding and compliance risk in loan documentation has become more settled.

In 2012, the LMA produced a series of riders for use with its facility documentation to allocate the risk of FATCA compliance and any tax deductions as agreed, which have since been updated a number of times. Rider 3, which entitles all parties to withhold as required, but imposes no gross-up or indemnity obligation on the borrower, has become the standard way of dealing with FATCA risk in loan documentation in Europe, regardless of whether the borrower group includes a US entity or has US-source income. Since 2014, the Rider 3 wording has been incorporated into the Investment Grade Agreements and certain other of the LMA’s templates, together with information-sharing provisions designed to facilitate compliance. The contractual treatment of FATCA risk still requires discussion in transactions involving lenders in non-IGA jurisdictions, where there remains some variation in the agreed positions.

The information-sharing provisions are deliberately worded widely enough to enable compliance with other exchange of information regimes, such as the OECD’s Common Reporting Standards (CRS) initiative. The CRS is sometimes referred to as ‘global FATCA’ but, unlike FATCA, it is simply an information-exchange regime and there is no withholding obligation. The information-sharing provisions require each party to confirm its FATCA status to the other parties and supply such information as is required for the purpose of that other party’s compliance with FATCA or any other law, regulation or exchange of information regime.

IV CREDIT SUPPORT AND SUBORDINATION

i Security

Types of security interests
Secured lending transactions typically involve a combination of security interests. Security can be taken over all asset classes and the choice of security interest depends on the nature of the asset and its importance in the context of the security package.

Under English law, there are four types of consensual security: pledge, contractual lien, mortgage and charge.
Pledges and contractual liens

A pledge is created through transfer of possession, where the pledgee has the power to sell the secured assets and to use the proceeds of sale to discharge the secured obligation. By contrast, under a contractual lien the lienee merely has a passive right of retention until the secured obligation has been performed.

The distinction between a pledge and a contractual lien is, however, of very limited practical importance in most corporate financing transactions. The reason for this is twofold and stems from a pledge and a contractual lien being possessory security interests. First, it is not possible to create a pledge or lien over future property or land, or over intangible assets that do not fall within a very limited category of documentary intangibles (such as bearer bonds). Second, although many companies are willing to provide security as part of the price of obtaining finance, they will often wish to retain the ability to use and deal with the secured assets, which will not be possible where the secured creditor has possession of the assets in question.

Mortgages

Mortgages involve the transfer of title to the asset in question to the lender by way of security, with a right to the transfer back of the mortgaged property when the secured obligation has been satisfied. A mortgage is legal or equitable depending on whether legal or equitable title is transferred. The form of transfer will depend on the nature of the asset in question and so, for example, mortgages over a chose in action (e.g., claims or receivables) involve the assignment of rights by way of security.

The steps required to transfer legal title to an asset and to create security by way of legal mortgage add a layer of complexity that may not be required at the outset of the transaction (see further below). In general, only freehold property, significant items of tangible movable property, aircraft and ships are the subjects of legal mortgages. In relation to other types of assets, equitable security is created and the secured creditor relies on contractual further assurance clauses and a security power of attorney to facilitate the transfer of legal title upon the security becoming enforceable.

Charges

A charge involves an agreement by the chargor that certain of its property be charged as security for an obligation. It entails no transfer of title or possession to the chargee.

In practice, there is little to distinguish a charge from an equitable mortgage, as enforcement rights such as a power to take possession, sell the secured assets and appoint a receiver are routinely included in documents creating charges. The more significant distinction is between fixed and floating charges.

Broadly, a fixed charge attaches to a specific asset and restricts the chargor from dealing with (e.g., disposing of) that asset. A floating charge generally attaches to a class of assets, and the chargor is permitted to deal with those assets in the ordinary course of business without

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4 An equitable mortgage arises either where the necessary requirements for a legal mortgage have not been met or where there is an agreement to create a legal mortgage. In practice, the distinction between legal and equitable mortgages, which is of relevance when determining priority rights, is reasonably straightforward to establish.

5 There are very few situations in practice in which it would be necessary to distinguish between the two. The reason for this is that the priority position of a fixed charge is virtually identical to that of an equitable mortgage, and the registration requirements are the same.
the consent of the chargee pending an event that causes the charge to ‘crystallise’. A typical floating charge will comprise the entirety of the borrower’s assets, whether existing or future, and whether tangible or intangible.

The main consequence of the characterisation of a charge relates to the ranking of payments on insolvency. For example, expenses of both liquidations and administrations are paid out of floating charge assets. These costs and expenses can be considerable, and may well exhaust the floating charge assets. A floating charge also ranks behind certain claims of certain preferential creditors (broadly, certain rights of employees) and, in respect of charges created on or after 15 September 2003, the ‘prescribed part’, a ring-fenced fund, is also paid out of floating charge assets to unsecured creditors in priority to the floating chargee. Unlike expenses, the priority of employees dismissed promptly following the commencement of insolvency proceedings and the amount of the ring-fenced fund are, generally, reasonably finite (the latter being currently capped at £600,000) and can be roughly calculated in advance by secured lenders.

The other key difference between fixed and floating charges is that the holder of a floating charge that constitutes a ‘qualifying floating charge’ (broadly, a floating charge relating to the whole or substantially the whole of a company’s property) enjoys very privileged appointment rights in an administration. It may appoint an administrator either in court or out-of-court at any time when the charge is enforceable, and is allowed to substitute its own preferred candidate in the place of an administrator proposed to be appointed by any other person.

These consequences have acted as a strong incentive to lenders to draft charge documents, known as ‘debentures’, which purportedly create fixed security over as many of the chargor’s assets as possible, combined with a sweeper floating charge over all of the assets of the chargor. However, when characterising a charge as fixed or floating, the courts will have regard to the commercial substance of the relationship between the parties. The label attached by the parties themselves will be largely irrelevant and, if it is inconsistent with the rights and obligations that the parties have in fact granted one another, the security will be recharacterised.

**Common methods of taking security**

The typical method of taking security over specific assets and any perfection steps depend on the nature of the asset. For example:

- **a** Real estate: title is transferred to the mortgagee in writing alongside the title deeds if a legal mortgage is to be created. An equitable mortgagee will also generally request delivery of the title deeds.

- **b** Registered shares: a legal mortgagee of shares must be registered as the legal owner, which may have adverse tax and accounting consequences for the lenders. Security is, therefore, often taken by way of equitable mortgage or fixed charge. To facilitate enforcement, the certificates for the shares are usually deposited with the chargee together with signed but undated forms of transfer. The articles of association are amended if necessary to ensure there are no restrictions on transfer in the event of enforcement.

- **c** Intellectual property rights: a legal mortgage or assignment of rights to intellectual property by way of security necessitates an exclusive licence back to the assignor to enable it to continue to use the rights, including a provision for reassignment on discharge of the security. It is, therefore, more common for such rights to be the subject of a charge.

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6 Under English law, perfection steps (other than registration at Companies House) generally relate to priority, and failure to take such steps does not mean a security interest will be invalid.
The appropriate method of taking security over claims and receivables such as book debts, bank accounts and cash varies. The key question is whether it is practical to create fixed security. If the intention is to create a fixed charge, the security document will need to contain adequate restrictions on the chargor’s ability to deal with both the asset and its proceeds, and those restrictions must be complied with in practice. This generally means that the proceeds of charged receivables must be paid into a blocked account. This may be achievable in relation to certain specific sums (e.g., the proceeds of a disposal that are to be used to prepay the loans). However, companies will need access to at least some of their bank accounts so fixed security will not be achievable in all cases.

**Formalities and registration**

Formal requirements for English-law security are minimal. For a variety of reasons, however, it is generally accepted that security documents should be executed as deeds.

Subject to limited exceptions, security interests created by English companies must be registered at Companies House within 21 days of creation, whether over assets in the United Kingdom or abroad and whether created under an English-law security document. If this is not done, the security will be void as against a liquidator, administrator or creditor of the company, and the secured liabilities will become immediately repayable.

In addition, certain types of assets (e.g., real property, ships, aircraft and certain intellectual property rights) may also be registered, generally for priority purposes, on specialist registers.

Registrations at Companies House and at the land and other specialist asset registries attract nominal fees.

**Particular challenges**

There are no specific categories of asset over which security cannot be granted or over which it is too difficult to create security under English law. However:

a third-party consent may be required to create some types of security over certain leased items (including leasehold real estate), and other contractual rights and receivables, which may be challenging to obtain;

b the limits of the distinction between fixed and floating charges can be uncertain, in particular in its application to cash and receivables; and

c it is not possible to create a legal mortgage of future assets. However, it is possible to create equitable security (equitable mortgage or charge) over future assets. The terms of the security document may require the chargor to take steps to convert the equitable security into a legal mortgage upon acquisition of the relevant asset.

The grant of security is also subject to the legal limitations outlined in Section V.

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7 The main exemption is for interests in shares and financial instruments, cash and credit claims that constitute ‘security financial collateral arrangements’ under the Financial Collateral Arrangements (No. 2) Regulations 2003. However, this exemption is not generally relied on in practice because of uncertainty as to how to interpret the requirement that the security asset must be within the control of the collateral-taker.
Guarantees and other forms of credit support
Guarantees must be documented in writing and are usually executed as deeds to prevent the guarantor from raising any questions about the existence or adequacy of consideration. Guarantees are the most common form of credit support in both secured and unsecured English-law financings.

The legal limitations outlined in Section V apply equally to the provision of guarantees.

Priorities and subordination

Priorities
The general rule under English law is that, as between competing security interests, the first in time normally prevails. However, this is subject in some cases to registration and other exceptions. The rules of priority are complex but might, very broadly, be summarised as follows:

a. Where registration at a specialist registry is required, the priority of competing interests is generally determined by the order of registration.
b. Registration at Companies House does not directly affect priority. Such registration may, however, constitute notice to third parties of the existence of the charge, which may affect the ranking of subsequent security.
c. The priority of successive assignments of a debt or other chose in action is governed by a common law rule under which an assignee who takes an assignment without notice of an earlier assignment and is the first to give notice of assignment to the debtor obtains priority over the earlier assignee.
d. A legal interest acquired for value and without notice (actual or constructive) of a prior equitable interest will normally rank ahead of the prior equitable interest.
e. Special rules apply to floating charges. The grant of a subsequent fixed charge or mortgage takes priority over a floating charge, unless at the time the subsequent security is created the floating charge places restrictions on the creation of further encumbrances (in the form of a negative pledge, which is customarily included in English-law financing documents) and the subsequent holder has notice of the restriction. For this reason, a note of the negative pledge is included in the particulars of the charge that are registered at Companies House, the intention being that anyone who searches the register will thereby acquire actual notice of the restriction. Registration at Companies House may also constitute constructive notice.

Ranking and subordination
Subordination in banking transactions is typically effected by the use of structural subordination (where ranking is determined by which company in the group is a debtor (either as a borrower or guarantor) to the junior and senior creditors) and contractual subordination (where creditors contractually agree to the ranking as among themselves). Contractual subordination is generally achieved through the use of an intercreditor or subordination agreement.

Contractual subordination is often coupled with a turnover trust as a fallback to maximise the recoveries of the senior creditors in an insolvency of the debtor. Under a basic trust subordination arrangement, the junior creditor agrees that any money it receives from the debtor in insolvency (e.g., in the event of mandatory insolvency set-off or other mandatory distribution contrary to the intercreditor agreement) will be held on trust for the
senior creditors to the extent of the senior debt. If effective, this has the advantage of giving the senior creditors a proprietary claim against the junior creditor, and means the senior creditors will not be exposed to credit risk on the junior creditor.

It is generally agreed that, as a matter of English law, contractual subordination should be enforceable as between the contracting parties.

In jurisdictions where trusts are not recognised, there is a risk that a junior creditor trustee will be treated as sole owner of the turnover property. There is also a limited risk that, in the event of an insolvency, the turnover trust provisions may be recharacterised as a security interest, which would be void for lack of registration. There is case law support for the proposition that a turnover trust provision will not be recharacterised as a charge if it is limited to the amounts required to pay the senior creditor in full and it is, therefore, generally thought that this risk can be mitigated with careful drafting.

V LEGAL RESERVATIONS AND OPINIONS PRACTICE

i Limitations on validity and enforceability of guarantees and security
The key issues when considering the validity and enforceability of guarantees and security are capacity and corporate benefit, financial assistance rules and the clawback risks that may arise in insolvency. These issues, which are discussed below, are frequently of theoretical concern only and are usually able to be dealt with as a practical matter in a typical transaction.

ii Capacity and corporate benefit
To grant valid guarantees and security, the grantor must have the requisite capacity and there must be adequate corporate benefit.

The corporate benefit analysis must be done on a company-by-company basis and any benefit received by other members of the group may not be relevant unless, for example, there is an element of reliance and financial interdependence between the companies. As well as carefully minuting the perceived benefits, if there is any doubt the security provider or guarantor may seek the approval of its shareholders. For a company that is solvent at the time of granting the guarantee or security, a unanimous shareholder resolution will act to ratify a transaction that might otherwise fall outside the scope of the directors’ powers, and is usually required by secured creditors as a condition precedent to funding in relation to upstream or cross-stream guarantees and security.

iii Financial assistance
The Companies Act 2006 restricts the provision of financial assistance, including security and guarantees, as follows:

a if the target is an English public company, neither the target nor any of its subsidiaries (public or private) may provide financial assistance for the purpose of the acquisition of the shares of the target or of reducing or discharging a liability incurred therefor; or

b if the target is a private holding company, no English public subsidiaries of the target may provide financial assistance for such purpose.

A number of exceptions apply but they are often not relevant in the context of secured lending. In practice, if security and guarantees are required from the target group following the acquisition, the relevant public companies in the target group will be re-registered as private companies before the financial assistance is given.
iv Clawback risks

Under English insolvency laws, the court has wide powers to set aside certain transactions. Guarantees and security provided by an English company or any foreign company subject to English insolvency proceedings may be at risk of being challenged by the insolvency officer if given within a certain period prior to commencement of liquidation or administration, and if certain other conditions are satisfied.

In the case of a guarantee, the most likely ground for challenge is that it represents a transaction at an undervalue or amounts to a preference. In the case of security, the most likely grounds for challenge are that the transaction constitutes either a preference or a voidable floating charge.

The vulnerability periods differ depending on the ground for challenge and are: six months for preferences (two years if the counterparty is a connected person); two years for transactions at an undervalue; and one year for a voidable floating charge claim (two years if the counterparty is a connected person).

v Preferences

For a transaction to be vulnerable as a preference, not only must it have been entered into within the specified period but the company must have been influenced by a desire to produce a preferential effect and must have been insolvent (as defined by statute) at the time of the transaction or become so as a result of entering into it.

vi Transactions at an undervalue

For a transaction to be vulnerable under Section 238 of the IA, it must have been a transaction at an undervalue within the meaning of Section 238(4) of the IA and entered into within the vulnerable period. Further, the company must have been insolvent (as defined by statute) at the time of the transaction or have become so as a result of entering into it. In practice, this ground for challenge is of relatively limited concern in most secured loan transactions because of the good-faith defence that is available. This defence applies if it can be shown that the transaction was entered into by the company in good faith and for the purposes of carrying on its business, and at the time it did so there were reasonable grounds for believing that the transaction would benefit the company.

vii Avoidance of certain floating charges

Under Section 245 of the IA, a floating charge may be set aside except to the extent of the value given to the company at the same time as or after the creation of the charge. If the parties are not connected, it is a defence if the company was solvent (within the statutory definition) when the charge was created and did not become insolvent as a result of the transaction.

Transactions, including security arrangements, may be vulnerable to challenge on other grounds, including that they offend the common law anti-deprivation principle, which invalidates, as a matter of public policy, any agreement providing for assets belonging to a company to be removed from its estate on insolvency.

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8 Section 238 Insolvency Act 1986 (IA).
9 Section 239 IA.
10 Section 245 IA.
Legal opinions practice

The practice of delivering legal opinions and the content of those opinions is well established in the English-law loan market. As a condition precedent to funding, lenders require opinions on the capacity and authority of each borrower and guarantor, and on the enforceability of the facility documentation, including any security documents.

The general expectation in loan transactions is that counsel to the creditors will deliver any legal opinions. This is usually the case in domestic transactions. In some circumstances, however, the borrower’s counsel will be called on to provide an opinion.

Syndicated loan opinions are typically addressed to the agent and the lenders forming part of the primary syndicate. Sometimes, where primary syndication takes place after the signing date (e.g., in the case of an underwritten acquisition facility), lenders who join the syndicate within a short period of the date of the agreement (e.g., three months) will be permitted to rely on the opinion.

Market practice has for some time been to permit the opinion to be disclosed to, but not relied on by, those who buy participations in the loan (or exposure to participations in the loan) on the secondary market.

No further reliance on or disclosure of the opinion is generally permitted without the opinion-giver’s consent.

VI LOAN TRADING

English-law syndicated loan participations are regularly traded, most commonly by way of transfer by novation, assignment or sub-participation.

Novation is the simplest and most common method and involves an outright sale of the participation. All of the seller’s rights and obligations in relation to the loan are cancelled and discharged, and are assumed by the buyer.

If a facility is secured in favour of the lender directly, the security will be released on the novation of the lender’s participation to a new lender. Security for syndicated facilities is, however, usually created in favour of a security trustee, who is appointed as trustee for the lenders from time to time. Use of a security trustee structure permits lenders to trade their participations without disturbing the effectiveness and priority of the security.

An assignment of rights to drawn loan participations (coupled with an assumption of equivalent obligations) is sometimes used as a hybrid method if transfer by novation would disturb security or guarantee arrangements, for example, in relation to certain foreign law governed arrangements.

The LMA’s facility agreement templates contain a framework to permit trading by novation or assignment.

The LMA templates do not restrict sub-participation or other trading methods such as trust or derivatives arrangements that do not involve a change to the lender of record under the facility agreement. Some borrowers negotiate those restrictions, but in most cases these trades can be effected without borrower consent. These methods of risk transfer should not disturb any security or guarantees provided in favour of the lender of record (or a security trustee acting on its behalf).
VII OUTLOOK AND CONCLUSIONS

The market outlook was altered significantly with the result of the United Kingdom’s referendum on EU membership, and Brexit remains the key risk factor on the horizon.

In November 2018, the parties concluded an agreement setting out the terms of the United Kingdom’s withdrawal from the European Union (the Withdrawal Agreement) and a political declaration on future UK–EU relations (the Political Declaration). The Withdrawal Agreement anticipates a transition period following the United Kingdom’s exit from the European Union during which the status quo will, in essence, be maintained, while the Political Declaration sets out the parties’ intention to develop an ‘ambitious, wide-ranging and balanced economic partnership’. However, the Political Declaration does not set out in detail the nature of the arrangements that the parties are seeking and, at the time of writing, neither the Withdrawal Agreement nor the Political Declaration have been approved by the UK parliament. Substantive amendments to both documents, the negotiation of alternative arrangements or the United Kingdom withdrawing from the European Union on a ‘no deal’ basis all remain possible.

Helping businesses across the European Union to reduce reliance on bank funding is a key plank of the European Commission’s landmark project to create a capital markets union, a project in which the United Kingdom will, in any event, cease to play a part going forward, but the impact of Brexit on the availability of finance and the products on offer over the longer term is difficult to anticipate. As was the case last year, there are few current indications that banks’ liquidity or funding positions have altered significantly, but it seems prudent to anticipate that lending criteria may tighten, and there are signs that banks are looking at the impact of Brexit on their customers when approving new loans. Treasurers may, therefore, focus again on alternative sources of finance.

In terms of legal and regulatory risks, the transition from LIBOR to risk-free rates will involve considerable changes to lending practices and documentation. Solutions for referencing risk-free rates in lending products are being examined and it is anticipated that this process will continue to accelerate during the course of 2019.
I OVERVIEW

Corporate lending remains the most prevalent source of financing for French corporate borrowers, through either syndication or club deals. As an alternative source of funding, French corporates and especially medium-sized to large corporates use private placements, thus allowing them to access institutional investors and diversify their financing sources.

For syndicated loans, the most widely used precedent remains the French law Multicurrency Term and Revolving Facilities Agreement published by the Loan Market Association.

A form of private placement has emerged on the French market since 2012: Euro Private Placements (Euro PPs), which are medium or long-term financings granted in the form of either a loan agreement or an issue of listed or unlisted bonds between a company and a small number of investors. In 2014, a model loan agreement and a model subscription agreement (for the issuance of bonds), each drafted in French and English, were published by the Bank of France and the French Treasury for use in the context of Euro PPs. In January 2016, the AMAFI\(^2\) published a Code of Best Practice for Euro PP arrangers. In addition, to render the French bonds market more attractive, the order dated 10 May 2017 modernised French law to simplify the development of bonds issues governed by it. Some amendments have simplified the applicable regime – in particular, by clarifying the obligations of the issuers – and other amendments were made to facilitate the regime where the bonds issued are subscribed by qualified investors. The amount borrowed under syndicated companies was around €144.7 billion in 2018 compared with €104.4 billion in 2017.\(^3\)

Notable recent deals in France include:

\(a\) the syndicated loan agreement for a total amount of €3.54 billion for Vivendi;\(^4\)

\(b\) the financing of Ramsay Générale de Santé’s tender offer on Capio AB through €450 million of subordinated bonds and a €750 million bank facility; and

\(c\) the term loan agreement for a total amount of US$11 billion by Axa for the acquisition of XL Group.\(^5\)

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1 Karine Sultan and Yves Rutschmann are partners, and Charlotte Bonsch, Béna Mara, Gaël Rivière and Guillaume Wulfowicz are associates at Bredin Prat.

2 Association française des marchés financiers.

3 Global Syndicated Loans Review, Full Years 2017 and 2018, Reuters.

4 Global Syndicated Loans Review, First Quarter 2019, Reuters.

5 Global Syndicated Loans Review, Full Year 2018, Reuters.
II LEGAL AND REGULATORY DEVELOPMENTS

i Reserved banking activities

Pursuant to Article L. 511-5 of the French Monetary and Financial Code (MFC), the ability to carry out credit transactions on a regular basis is, in principle, subject to the monopoly of licensed credit institutions (banks) and finance companies (together with licensed credit institutions and authorised entities). Finance companies were created in 2013 in France, and may only carry out credit transactions and, subject to exceptions, do not benefit from the European passport. In 2018, 175 finance companies were registered in France.6

These restrictions are known as the ‘banking monopoly’. This monopoly also extends to receiving funds from the public and providing banking payment services, which can only be carried out by credit institutions (notwithstanding the possibility for payment institutions to provide payment services aside the banking monopoly regulations).

Subject to certain conditions defined by EU law, an entity authorised to carry out banking activities (such as carrying out credit transactions) in a European Economic Area (EEA) Member State is entitled, if it chooses, to carry out the same permitted activities in any other EEA Member State by either exercising the right of establishment (through a branch or agents) or providing cross-border services.

Thus, a licence would be required for an entity to carry out what qualifies as credit transactions in France on a regular basis.

Breach of banking monopoly rules constitutes a criminal offence (with penalties of up to three years’ imprisonment and a fine of up to €375,000).

A credit transaction is defined by Article L. 313-1 of the MFC as any act whereby a person, acting in exchange for payment (fees, interest or any other kind of payment), provides or promises to provide funds to another person or an undertaking on behalf of another person.

The term ‘credit transaction’ is therefore broad in scope and covers many types of transactions.

Exceptions to the banking monopoly

The banking monopoly regime is subject to a number of exceptions set out in the MFC and the French Commercial Code, including the issuance or subscription of bonds, deferred payment terms, vendor loans, intra-group loans (i.e., credit transactions between entities under common control) and loans granted to a company by direct shareholders owning at least 5 per cent of the share capital of the company.

Certain specific entities that are not authorised entities may, in certain circumstances, carry out credit transactions, such as insurance companies, payment services providers, crowdfunding platforms, or certain funds, including in particular those that are recognised as European long-term investment funds and certain alternative investment funds.

The Macron Law, which was adopted in August 2015, introduced a new exception to the banking monopoly. Under the new law, limited liability companies can extend loans with a maturity of less than two years to small and medium-sized enterprises with which they have business relationships. A decree released on 24 April 2016 sets out the various business

6 2018 ACPR Annual Report.
relationships under which enterprises are authorised to extend loans, and the maximum annual amount of such loans per borrower and in aggregate, depending on the size, the net cash and cash equivalent of the lending company.

To facilitate cross-border transactions, Order No. 2017-1432 of 4 October 2017 introduced a new exception that allows, since 1 January 2018, certain foreign entities and institutions to acquire professional non-matured loan receivables from French regulated entities. Eligible foreign acquirers must have an activity or corporate purpose similar to those of certain entities authorised to lend in France pursuant to applicable banking monopoly rules.

A new exception was also introduced by Law No. 2018-1021 of 23 November 2018 as regards certain credit operations among entities belonging to a social housing organisation group.

ii Authorised entities and prudential obligations

Banking licences have been granted to credit institutions by the European Central Bank (ECB) since 4 November 2014. However, a filing must be made with the French banking regulator (ACPR), which assesses all applications and forwards draft decisions to the ECB. Moreover, licences for finance companies are still granted by the ACPR.

Credit institutions considered as ‘important’ in accordance with Council Regulation (EU) No. 1024/2013 are supervised directly by the ECB, whereas less important credit institutions and finance companies are directly supervised by the ACPR.

To be licensed as a credit institution or a finance company, an institution must meet certain prudential requirements relating to its share capital, and its maintenance of solvency and liquidity ratios. Additional requirements pertaining to the governance and the internal organisation of the credit institution or finance company must be met (e.g., appointment of control officers, a compliance officer or a risk management officer).

iii Impact of Basel III, the Bank Recovery and Resolution Directive, the Capital Requirements Regulation, the Capital Requirements Directive IV, sanctions and anti-corruption laws

The impact of the implementation of global regulatory regulations such as Basel III, the Bank Recovery and Resolution Directive, the Capital Requirements Regulation and the Capital Requirements Directive IV is difficult to assess with respect to corporate lending, even if such measures certainly affect the pricing of loans made by banks.

However, as far as documentation is concerned, these regulations impact the ‘increased-costs’ provisions pursuant to which the costs of compliance with the regulations are to be borne by the borrower. These increased-costs clauses are usually heavily negotiated by French corporates.

In addition, the increasing range of sanctions and anti-corruption laws implemented around the world (in particular, sanctions imposed by the Office of Foreign Assets Control of the US Treasury Department, the ACPR and the French anti-bribery agency), as well as their significant extraterritorial effect and their consequences in the event of breach (as illustrated by the US fine imposed on BNP Paribas in 2014 or by the French fine imposed on La Banque Postale in 2018), has led many lenders to seek specific representations and undertakings.

7 The Capital Requirements Regulation and Directive.
from the borrower in relation to these matters. These are not only required in most loan
documentation negotiated recently, but also by arrangers and initial purchasers in the context
of French law bond issues through representations or due diligence questionnaires.

III TAX CONSIDERATIONS

i Deductibility of interest for borrowers

General rules
Interest expenses incurred by a company subject to French corporate income tax are generally
deductible for tax purposes, subject to the specific limitations or anti-abuse rules described
hereinafter, provided that the following criteria are simultaneously met:

a the debt has been incurred for the direct purpose of the business carried out by the
   borrowing company;

b the debt is duly recorded in its balance sheet for accounting purposes;

c the financial terms and conditions of the debt are set at ‘arm’s length’; and

d the debt service (i.e., repayment of principal and payment of interest charges) does
   not exceed the financial capabilities of the borrowing company nor deprive it of the
   necessary funds to meet any reasonable foreseeable investment needs.

Definition of a related party
All references to ‘related parties’ below mean two companies where:

a one company controls (directly or indirectly) the other; or

b they are controlled directly or indirectly by another company.

A company is considered as controlling another company if:

a it holds the majority of the share capital of that company; or

b it de facto manages that company.

Specific limitation rules
The rules limiting the deductibility of interest expenses paid to shareholders or related parties
(including thin capitalisation rules) are as follows:

a Interest paid by a French company to its shareholders who do not qualify as related
   parties is only deductible within the limit of the average annual interest rate for certain
   loans granted by banks (1.47 per cent for fiscal year 2018 coinciding with the calendar
   year), provided that the borrower’s share capital is fully paid up.

b Interest paid by a French company on loans granted by related parties is only deductible
   within the limit of the interest rate defined above, or, if higher, the interest rate that
   independent financial institutions would have applied under similar circumstances.

c The ‘anti-hybrid limitation’ provides that interest paid by a French company to related
   parties is only deductible if the borrower can demonstrate that, for the same fiscal
   year, the lender is subject to income tax on this interest for an amount at least equal to
   25 per cent of the French corporate income tax as determined under standard rules.

d France adopted, on 1 January 2019, a new set of rules concerning interest deduction
   and thin capitalisation, based on the Anti Tax Avoidance Directive (ATAD) (Directive
   (EU) 2016/1164 dated 12 July 2016):
• The reform limits the deductibility of interest if and to the extent that the net borrowing costs of the French taxpayer (towards both related and unrelated parties) exceed the higher of 30 per cent of its EBITDA⁸ or €3 million. For taxpayers that are members of a French tax consolidated group, the rules apply at the level of the group result and do not apply to interest paid between members of the same group.

• EBITDA is calculated based on the taxpayer’s income subject to French corporate income tax for a given fiscal year (and before offsetting losses of prior fiscal years), adjusted with amounts for netted amortisation, deductible provisions, net borrowing costs, and certain capital gains or losses subject to reduced corporate income tax rates.

• Net borrowing costs refers to the excess of deductible financial expenses over taxable financial income received by the company.

• Companies (or French tax consolidated groups) that belong to a consolidated group for financial accounting purposes may benefit from a safe harbour clause: they are able to deduct an additional 75 per cent of the amount of net borrowing costs not allowed for deduction under the above-mentioned general limitation, provided that the ratio between their equity and their total assets (assessed at the level of the French tax consolidated group as the case may be) is equal to or greater than the same ratio determined at the level of the consolidated group to which they belong.

• Non-deductible interest could be carried forward indefinitely, except if the company qualifies for the application of thin-capitalisation rules, where the interests that cannot be deducted under the second limitation cannot be carried forward (cf. below).

• Unused interest capacity (i.e., the positive difference between the applicable thresholds and the amount of interest deducted during a given fiscal year) may also be used to increase interest deductibility during the subsequent five fiscal years, except if the company qualifies for the application of thin-capitalisation rules, where none of the unused interest capacity can be carried forward.

Special rules apply in the case of thin capitalisation, namely where a company’s indebtedness towards related parties exceeds 1.5 times its net equity for a given fiscal year. As the case may be, a twofold mechanism is to be applied to determine the total amount of interest that can be deducted:

• First, a ratio between the company’s indebtedness to unrelated companies (increased by 1.5 times its net equity) and the company’s total indebtedness must be computed. A first limitation is determined by multiplying this ratio by the higher of 30 per cent of the taxable EBITDA or €3 million. Within this limit, a first amount, (A), equal to the net financial expenses that multiplies the ratio, is deductible.

• Second, another ratio between the company’s indebtedness to a related party (diminished by 1.5 times its net equity) and the company’s total indebtedness must be computed. A second limit is determined by multiplying this ratio by the

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⁸ Earnings before interest, tax, depreciation and amortisation.
higher of 10 per cent of the taxable EBITDA or €1 million. Within this limit, a second amount, (B), equal to the net financial expenses that multiplies the ratio, is deductible.

- The total amount of interest that can be deducted results from the addition of the deductible amount determined by the application of both rules (A+B).
- A safe harbour rule is provided for if, for the given financial year, the ratio between the total indebtedness and the equity of the consolidated group to which the concerned company belongs is greater than or equal to its own ratio.
- A thin-capitalised company is deprived of the 75 per cent deduction supplement for members of consolidated groups. As mentioned above, special carry-forward rules concerning non-deductible interest and unused interest capacity shall apply.

Anti-abuse rules may apply in specific acquisition scenarios where a French target is acquired and subsequently included in the tax-consolidated group to which the acquirer belongs, if the seller directly or indirectly controls the head of the tax-consolidated group, or is controlled directly or indirectly by the persons who directly or indirectly control the head of the tax-consolidated group.

These limitation rules shall apply following the order specified by the law and the French tax authorities in their guidelines, it being specified that particular rules apply within French tax consolidated groups and, more generally, the French tax law provides for various general anti-abuse rules that may apply to interest deduction. Furthermore, specific anti-abuse rules may apply in cross-border contexts. Interest paid by French companies to entities located in low-tax jurisdictions is only deductible if the borrower proves that the interest corresponds to real transactions and is not excessive. For interest due to entities located in a non-cooperative state or territory (NCST) (states or territories that do not apply international standards with respect to exchanges of tax information, and have not concluded with France and at least 12 other states or territories a convention on administrative assistance allowing the exchange of information necessary for the application of their respective tax laws), the borrower must further demonstrate that the main purpose and effect of the transaction are not to transfer income to the NCST.

The French list of NCSTs was amended on 23 October 2018 to include the states and territories, other than those of France, that are considered as NCSTs by the European Union, listed in Annex I of the revised EU list of NCST published on 5 December 2017 and revised on 12 March 2019. In this respect, French legislation distinguishes between (1) the states and territories included in the EU list on the ground that they facilitate the creation of extraterritorial structures or devices intended to attract benefits that do not represent real economic activity, and (2) the states and territories included in the EU list because they do not meet at least one of the other EU criteria defined by Annex V of the list, namely tax transparency, the absence of preferential tax measures that are potentially harmful or the implementation of the BEPS (Base Erosion and Profit Shifting) project. This amendment will be effective three months after the publication of the related ministerial ruling, the communication date of which has not been given yet.

On 29 May 2017, the Council adopted the Anti Tax Avoidance Directive (Directive (EU) 2017/952) (ATAD 2) amending the ATAD as regards hybrid mismatches with third countries and encompassing forms of hybrid mismatches not covered by ATAD (in line with the Organisation for Economic Co-operation and Development (OECD) and G20 recommendations). Member States shall, by 31 December 2019, adopt and publish the laws,
regulations and administrative provisions necessary to comply with ATAD 2, and shall apply those provisions, which may amend existing French provisions, from 1 January 2020 (and 1 January 2022 for the implementation of reverse hybrid mismatches).

ii Withholding taxes on payments to lenders
Interest paid by French companies to non-residents is not usually subject to any withholding tax, except for interest paid outside France in an NCST, which is subject to a 75 per cent withholding tax, unless the company proves that the main purpose and effect of the transaction are not to transfer income to the NCST. This additional withholding tax will concern, as of the entry into force of the amendment mentioned in subsection i, the NCST that are mentioned in the French list and in the first category of the EU list. The states or territories mentioned in the second category of the EU list will not be concerned by this measure.

iii Documentary and transfer taxes
France does not levy any documentary or transfer taxes on loan agreements.

iv Impact of the FATCA
The Foreign Account Tax Compliance Act (FATCA) was enacted by the United States in 2010 to combat offshore tax evasion by US persons. On 14 November 2013, the French Minister of Economy and Finance and the US ambassador to France signed a bilateral intergovernmental agreement intended to implement the FATCA, which was implemented in France by Law No. 2014-1098, dated 29 September 2014.

v OECD Common Reporting Standard

IV CREDIT SUPPORT AND SUBORDINATION
This section describes current applicable French legal framework that could be modified pursuant to the draft bill described in Section VII.

i Security
Security interests over an asset must be granted in accordance with the specific set of rules applying to the category to which the asset belongs. Security packages are therefore most often documented through several separate security documents (although some law firms have recently started covering several unregistered security interests in one single security agreement).
Below is an overview of certain types of security interests that may be granted over assets located in France.

Registration always requires the payment of fees (the amount of which represents a percentage of the secured obligations for mortgages and security trusts while registration fees for other registered securities are nominal) and a renewal of the registration on occasion to maintain the effectiveness and ranking of the security interests.

All registered security interests must be drafted in French to allow registration with the relevant authorities for validity or perfection purposes and cover the relevant mandatory points required by law to be valid.

**Security interests over real estate**

**Mortgages**

Mortgages are granted over lands and buildings. To be valid, they must be executed before a public notary. To be perfected, they must be registered with the land registry, which will trigger the payment of various costs, including the real estate registration tax.

**Security trusts**

Security trusts require rights and assets (whether present or future) to be transferred to a trustee acting in favour of the secured creditor. The assets held by the trustee of the security trust are segregated from its own assets. They are generally used in restructuring transactions where the assets of the borrower consist of real estate.

To be valid, security trusts must be registered with the local tax authorities within one month of their execution.

**Security interests over tangible movable property**

**Pledges over a business**

Pledges over a business are granted over the business and cover at least the trade name, the leasehold rights where the business is operated and the goodwill of the business. If expressly provided and identified in the pledge agreement, the scope of the pledge may extend to fixed assets such as furniture, machinery, equipment and intellectual property (IP) rights attached to the business. The secured creditors may also decide to pledge machinery, equipment or IP rights under the specific regimes described below.

To be valid, they must be registered with the tax authorities and then with the registrar of the commercial court within 30 days of execution.

Registration requirements are described below, for situations where the IP rights are included within the scope of the pledges over a business.

**Pledges over inventory**

Pledges over inventory may be created in accordance with the French Civil Code (civil law pledges) or with the French Commercial Code (commercial law pledges).

To perfect a civil law pledge, it must be registered with the registrar of the relevant commercial court or the pledgor must effectively transfer possession and control of the pledged assets. The transfer is usually carried by a third-party service provider, which then undertakes certain obligations.

Since an order dated 29 January 2016, with respect to contracts entered into after 1 April 2016, the regime of the commercial law pledge has been simplified. However, the
availability of a commercial law pledge is still limited, as the beneficiary of the pledge can only be the credit institution (see Section II) that has extended the financing secured by the security interest.

To be enforceable against third parties, the pledge must contain mandatory provisions and be registered with the registrar of the relevant commercial court.

Recent case law decided that the use of civil law pledges is only possible in instances where the conditions for creating commercial law pledges are not met. However, the above-mentioned order dated 29 January 2016 has expressly provided that parties can freely decide from 1 April 2016 whether to use a civil law pledge or a commercial law pledge.

**Pledges over machinery and equipment**

Pledges over machinery and equipment can only be granted to the seller, the credit institution financing the payment of the purchase price or the guarantor guaranteeing payment of the purchase price for the identified machinery and equipment over which the pledge is created to secure the payment. They must be directly granted in the sale agreement or the financing agreement.

To be valid, it must be granted within two months of delivery of the relevant machinery and equipment, and be registered with the tax authorities and then with the registrar of the commercial courts within 15 days of execution.

**Security interests over shares and financial instruments (securities)**

**Pledges over securities accounts**

Pledges over securities accounts are governed by the MFC and are only relevant where the securities to be pledged are issued by a French limited liability company that is not a limited liability partnership. They apply to the securities account on which the securities and future securities held in the name of the pledgor are registered. The securities account is opened in either a paper format register held by the issuer of the securities or in an electronic format register by a regulated intermediary authorised by law to hold such accounts (the pledged securities account holder).

These pledges are created by the execution of a statement of pledge drafted in French, containing mandatory provisions and covering both the securities account where the securities held in the name of the pledgor are registered, and the special proceeds account opened in the name of the pledgor in the books of a bank or of the pledged securities account holder, where all dividends pertaining to the securities are transferred.

In practice, the security interest is registered in the securities transfer register and in the security holders’ accounts of the French company.

**Pledges over partnership interests**

Pledges over partnership interests are governed by the French Civil Code and are applicable only to shares issued by limited or unlimited liability partnerships (which are not limited liability companies). As such partnerships are ‘closed companies’, granting such pledges requires the secured creditors to be approved by the shareholders as potential future shareholders.

To be perfected, they must be registered with the registrar of the commercial court.
Security interests over contractual rights, receivables and intangibles

Pledges over receivables

Pledges over receivables (including pledges over a bank account) are governed by the French Civil Code and must properly identify the pledged receivables and the relevant debtor or debtors.

With respect to a pledge over a bank account, the pledged receivables will correspond to the amount of credit in the bank account at the time the pledge over the bank account is enforced, after taking into account debits and credits previously initiated but not yet completed.

As between the parties and towards third parties, the pledge is perfected as soon as it is executed, whereas a notification is required to perfect the pledge towards the debtor of the receivables.

Dailly assignments

‘Dailly’ assignments are security interests where a company makes an outright transfer of any claims it may have over identifiable receivables arising out of its professional activity. They are only available where the beneficiary of the assignment is a credit institution (see Section II) that has extended the financing secured by the security interest.

To be valid, a Dailly assignment must be drafted in French and contain mandatory provisions, and must be perfected on the date specified by the secured creditor in the Dailly assignment.

The debtor of the receivables must be notified if the secured party wants to receive all payments pertaining to the receivables.

Cash collateral

Cash collateral is created by transferring cash to the credit of a bank account belonging to the secured creditor.

Pledges over IP rights

Pledges may be granted over all kinds of IP rights such as patents, trademarks or designs. To be perfected, they must be registered with the French Trademark and Patent Office and published in the Official Bulletin of Industrial Property.

ii Guarantees and other forms of credit support

Guarantees are commonly used in France and granted by the parent company as well as significant subsidiaries of the group (see Section V, ‘Corporate benefit and misuse of corporate assets’ and ‘Financial assistance’), whereas other forms of credit support are limited.

With respect to guarantees, as of 2006, guarantees have been governed by one chapter of the French Civil Code and may take three forms: joint and several guarantees, autonomous guarantees and letters of intent.

iii Priorities and subordination

As in other jurisdictions, financial indebtedness can be subordinated in two ways: through structural and contractual subordination.
Structural subordination, where senior debt is made directly available to operational companies, whereas mezzanine and junior debt is only made available to the acquisition vehicle, cannot be effected in respect of corporate lending for a single borrower and therefore is usually only seen in acquisition finance contexts.

Contractual subordination through subordination agreements is commonly used, and the effectiveness of these agreements has been recognised by Article L. 626-30-2 of the French Commercial Code in the context of safeguard proceedings. However, the effectiveness of contractual intercreditor arrangements is not free from doubt since there are no published decisions of any French courts on their validity or enforceability.

V LEGAL RESERVATIONS AND OPINIONS PRACTICE

i Legal reservations

Corporate benefit and misuse of corporate assets

The relevant entity must consider its corporate benefit before guarantees or security interests are granted. The concept of corporate benefit is not clearly defined by French law and French courts will assess, after the event, whether the decisions taken by the directors of the company were in fact prejudicial to the company.

Failure to act in a company’s corporate interest puts the relevant directors at risk of becoming as follows:

a liable for damages on the basis of their alleged mismanagement; and

b criminally liable on the basis of misuse of a company’s assets or credit. For individuals, the penalties are five years’ imprisonment and a fine of up to €375,000.

As boundaries of the concept of ‘group-wide corporate benefit’ remain rather vague under French law, current market practice has designed (in relation to upstream or cross-stream guarantees) guarantee limitation clauses ensuring that a French guarantor’s liability under its guarantee is limited to the financing proceeds directly or indirectly lent on to the French guarantor.

Financial assistance

Under French law, it is prohibited for French limited liability companies that are not limited liability partnerships that are being acquired, and for their subsidiaries, including foreign subsidiaries (e.g., if the foreign subsidiary has French assets over which security is to be created), to give any guarantees or grant security interests over their assets to secure the amounts used to acquire them.

Financial assistance issues must also be considered when merging the acquisition vehicle and the target, or when implementing debt pushdowns (in particular, where the target group draws further new facilities, the proceeds of which are to be used as a dividend allowing the acquisition vehicle to repay the initial acquisition indebtedness).

Breaching Article L. 225-216 of the French Commercial Code is a criminal offence that exposes the directors of the company to a fine of up to €150,000. Moreover, French commentators consider that transactions not complying with Article L. 225-216 could be voided by French courts.
Insolvency, security interests and the suspect period

The onset of court-driven proceedings (i.e., liquidation proceedings, reorganisation proceedings and several types of safeguard proceedings) triggers a general stay of certain claims (predating the proceedings) including:

a. a stay of claims for payment having arisen prior to the judgment opening the relevant proceedings; and
b. a stay of all enforcement action in respect of security interests.

French insolvency law provides for a ‘suspect period’, extending backward in time from the date of the judgment opening recovery or liquidation proceedings to the time when a company becomes unable to settle its liabilities as and when they fall due with its available assets. This time may be backdated to the date falling 18 months prior to the opening judgment.

Certain transactions entered into during the suspect period are automatically void. In particular, French law provides for the automatic nullification of the granting of pledges and mortgages that have been constituted during the suspect period to secure pre-existing indebtedness.

Some other transactions are voidable at the court’s discretion, particularly if the court determines that the creditor knew of the debtor’s suspension of payments at the time of the relevant transaction (including repayment of debts that are due and payable, and transfers of assets for consideration).

ii Legal opinion practice

Characteristics of French legal opinions

There is sufficient consensus on issues relating to French legal practice for French legal opinions to be relatively standardised.

Capacity legal opinions (covering due incorporation, due corporate action and due authority of the relevant signatories) are usually delivered by counsel to the borrower whereas French law validity legal opinions (covering validity and enforceability of French-law governed documentation) are usually delivered by the legal adviser of the lenders or the bonds’ initial purchasers. There are exceptions to these principles in the context of the issuance of high-yield bonds or where US parties are involved, in which case French practice is increasingly that legal advisers of the issuer and the bonds’ subscribers both provide validity opinions as to the security package on the transaction.

Addressees of legal opinions usually include the security agent or trustee (where applicable), the arrangers, the initial purchasers (for bond transactions) or the facility agent, and the initial lenders (for loan transactions). The provision of copies of legal opinions (without reliance) is usually permitted in respect of the affiliates, auditors and advisers of the addressees, as well as courts, regulatory authorities, and potential assignees or transferees.

French legal opinions usually contain standard qualifications relating to:

a. the use of a security agent if no security agent is appointed pursuant to Article 2488-6 et seq. of the French Civil Code;
b. lower-ranking security interests;
c. the effectiveness of ‘parallel debt’ structures if no security agent is appointed pursuant to Article 2488-6 et seq. of the French Civil Code; and
d. the effectiveness of any pledges of future receivables that are not identifiable or properly identified.
iii Choice of foreign governing law

In accordance with Regulation (EC) No. 593/2008, dated 17 June 2008, the choice of foreign law to govern a financing is a valid choice of law that would be upheld under French law unless the choice is tainted with fraud, or it conflicts with French international public policy or French mandatory provisions, and provided that the relevant provisions of foreign law are produced in evidence before the French courts.

iv Recognition of foreign judgments

Decisions by European courts against a debtor are normally enforceable before French courts in accordance with Council Regulation (EC) No. 44/2001, dated 22 December 2000.

For non-European countries and in the absence of a bilateral agreement between France and the country where the judicial decision has been rendered, recognition is subject to the conditions required for exequatur: the foreign court must have jurisdiction over the case in accordance with French rules of private international law; and the decision must not contravene French international public policy rules or be tainted with fraud, and must not conflict with any proceedings or decisions having the same subject matter as a French judgment.

VI LOAN TRADING

Transfers of existing loan participations between existing and new lenders are mostly effected through assignments of receivables or through sub-participations. The assignment must be in writing or it will be declared void, and needs to be notified to or acknowledged by the debtor to be enforceable regarding the debtor. The securities provided by the assignor will remain enforceable.

The 2016 order mentioned in Section IV introduced, in particular, provisions relating to assignments of debts and assignments of contracts. Assignments of debts will be possible with the approval of the creditor, which can be given in advance. In addition, following the law dated 20 April 2018, entered into force on 1 October 2018, an assignment of debts must be in writing or it will be declared void. The creditor must also give express consent to free the initial debtor; in the absence of consent and unless otherwise provided, the debtor will still be considered as a joint debtor until full repayment of the debt by the assignee. If the creditor does not free the initial debtor, the securities will remain enforceable. Otherwise, to remain enforceable the initial debtor and third parties that granted securities must give their consent to maintain the securities. With respect to guarantees, the guarantors will still be liable under their guarantees and the guarantee will be reduced by the amount of the assigned debt. Assignment of contracts follows the same logic as assignment of debts.

Novation is rarely used, as the validity and priority over security interests would be affected.

i Loan trading and banking monopoly

The purchase of unmatured debt (i.e., the transfer from a lender of its participation in a facility) constitutes a credit transaction to which the banking monopoly rules (see Section II)
apply, and as such can only be carried out by authorised entities or foreign similar entities with respect to the purchase of professional non-matured loan receivables (see Section III) if it is deemed to be carried out in France.

The mere holding of a participation or a sub-participation in a loan to a French borrower is generally not considered by practitioners as a credit transaction to the extent that the loan has already been made available to the borrower and that no further drawing will be required from the lenders (i.e., term loans and non-revolving loans).

ii Loan trading and transfer of security interests

The assignment of receivables entails the automatic transfer of all accessory features relating to the receivables (including the benefit of personal guarantees and security interests securing the receivables). Notable exceptions include Dailly assignments as they may only be provided for the benefit of credit institutions and cash collateral accounts that are the property of the bank to which they were initially granted, although they are subject to a restitution claim for the same amount.

The customary practice under French law documentation had been to grant security for the benefit of all finance parties directly as opposed to a security agent alone, since French practitioners did not rely on Article 2328-1 of the French Civil Code, which was introduced in 2007 purportedly to allow French security agents to manage security interests on behalf of the other creditors, owing to uncertainties and the incompleteness of its regime. However, the order of 4 May 2017, entered into force on 1 October 2017, replaced, improved and clarified the former legal regime under Article 2488-6 et seq. of the French Civil Code. This new regime provides, in particular, that the security agent is now a beneficiary of the in rem or personal guarantees that are segregated from its own assets, can be appointed in any written agreement and can take certain legal actions in bankruptcy proceeding without a special power granted by the finance parties. French practitioners now rely on this new legal framework to grant security only for the benefit of the security agent.

In the context of cross-border transactions with main documents not governed by French law, parallel debt structures can still be used, but those provisions are now less relevant for France if a security agent is appointed in accordance with Article 2488-6 et seq. of the French Civil Code. This concept has received only partial recognition by French case law, as it was held (in the very specific context of safeguard proceedings opened in France) that such structures governed by foreign laws were compatible with French international public policy rules. It remains to be seen whether these structures will be upheld by French courts in more general contexts.

VII OUTLOOK AND CONCLUSIONS

i Significant legal and regulatory developments

The past few years have witnessed an incremental erosion of the banking monopoly regime.

A bill authorising the government to legislate by issuing an order to simplify and update the French legal framework of guarantees and security interests is currently being debated in Parliament. It contemplates modernising guarantees, pledges over movable and intangible assets and security interests over real estate regimes, and creating new legal instruments to grant a French law-governed assignment over receivables as distinct from Dailly assignments.
ii Outlook for the lending market

It is likely that the general disintermediation of the French corporate lending market will continue for the time being, along with a further diversification of available funding sources (and further inroads into the banking monopoly regime), to reflect the emergence of new market players and the development of partnerships between traditional banks and investment funds. The competitiveness of corporate lending by credit institutions has continued owing to a friendly interest rate environment.

It is also likely that the French corporate lending market will witness some changes given the impact of Brexit and the development of green loans.
Chapter 8

GERMANY

Christian Schmies, Nikolaus Vieten and Jens Wenzel

I OVERVIEW

In 2018, the German corporate lending market remained stable and active, with event-driven financings sparking activity despite the mergers and acquisitions markets falling short of their record highs in the previous years and slightly fewer opportunistic refinancings taking place.

The availability of debt capital across the various debt products generally continues to remain high and, as a result, German borrowers continue to benefit significantly from very borrower-friendly commercial and contractual conditions. Funding continues to be available for deals of any size and purpose, including multibillion-euro acquisition financings for large German corporates.

In addition to the syndicated loan market, the Schuldschein market (an established German version of a private placement with a long-standing history) has remained very liquid and active, with attractive commercial conditions for investment-grade borrowers, and – as in 2016 and 2017 – several jumbo issuances. Despite few first restructurings in relation to Schuldschein borrowers having occurred, Schuldschein loans continue to be available for non-investment grade borrowers and foreign issuers, but with an increasing focus on diligence and appropriate contractual terms. It remains to be seen whether Schuldschein lenders will ultimately start to refocus on investment-grade borrowers.

Debt-fund financings, including unitranche, have further stabilised their position in the German market. They have become a real second source for mid-market financings, especially for sponsor-driven deals.

In the syndicated lending market, the prevailing documentation standard is the Loan Market Association (LMA) standard. In fact, a dedicated German law-governed multi-currency facilities agreement LMA precedent for investment-grade borrowers exists. There is also a dedicated German law-governed real estate finance facility agreement for multi-property investment transactions.

In contrast, the Schuldschein market has, so far, not used harmonised documentation but in-house templates by the arranging banks, which at first glance may differ from arranger to arranger, but in substance are largely similar. Last year, the LMA published a template for Schuldschein loan documentation, which was developed together with several banks and law firms. It remains to be seen whether this LMA template will gradually replace the existing in-house documentation.

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II LEGAL AND REGULATORY DEVELOPMENTS

Unlike many other jurisdictions, lending in Germany is generally a regulated activity that requires a banking licence under the German Banking Act if performed commercially or in a manner requiring a commercial business organisation. The licensing requirement applies irrespective of whether loans are granted to consumers or to non-consumers. According to the administrative practice of the German Federal Financial Services Supervisory Authority, the licensing requirement also applies to lenders domiciled abroad if they actively approach borrowers domiciled in Germany to grant loans. Not only the granting of a new loan but also the mere restructuring of a loan that has been acquired from the original lender (e.g., by extending maturity, adjusting interest rates) may qualify as lending activity requiring a banking licence.

The German Banking Act provides for certain exemptions from the requirement of a banking licence for lending business, in particular, for insurance companies granting loans as part of their activities permitted under German insurance regulation. Furthermore, portfolio management activities by German, EU or EEA undertakings for collective investments in transferable securities (UCITS), management companies and alternative investment fund managers (AIFMs) are not subject to the licensing requirement under the German Banking Act. Though UCITS are generally not allowed to invest in loans from an investment regulatory perspective, EU or EEA AIFMs may, depending on the laws of their home state, be allowed to originate loans for alternative investment funds (AIFs) they manage. As the origination of such loans for AIFs managed by an AIFM is part of the AIFM’s portfolio management activities, an EU or EEA AIFM can extend such loans to borrowers domiciled in Germany without being exposed to licensing requirements under the German Banking Act. Fund managers and funds domiciled outside the European Economic Area only benefit from the exemption if the relevant fund may be marketed in Germany, which requires successful completion of a notification procedure. The relevant statutory provisions in this respect make clear that a mere notification for marketing to professional or semi-professional investors, which is easy in comparison with a notification for marketing to retail investors, is insufficient. In practice, this implies that the vast majority of non-EEA loan funds will still not be in a position to actively offer the extension or restructuring of loans to borrowers domiciled in Germany.

German funds remain subject to investment regulatory restrictions on lending. Except for special provisions applicable to shareholder loans, loans can generally only be originated by closed-ended German ‘special funds’ (i.e., funds restricted to professional or semi-professional investors, an investor category autonomously created by the German legislator). Loans to consumers are not permitted. A single loan may not account for more than 20 per cent of the fund’s assets, and a German loan fund itself may only incur limited leverage (i.e., borrowing by the fund must not exceed 30 per cent of the fund’s aggregate or committed capital). Fund managers managing loan funds are subject to additional organisational requirements on loan processing, which essentially replicate corresponding requirements applicable under German banking regulation to credit institutions.

Although the Basel III framework has largely been incorporated into German law because of the German implementation of the Capital Requirements Directive IV (CRD IV) and the Capital Requirements Regulation IV, which are directly applicable in Germany, banks still argue in credit agreement negotiations that they continue to be unable to factor the Basel III or CRD IV cost effects into their internal margin calculations. They, therefore,
require borrowers to accept explicit carve-ins for the coverage of increased costs triggered by Basel III or CRD IV, even though the increased costs regime generally denies the coverage by the borrower if the legal framework already existed when the credit agreement was executed.

Huge penalties imposed on US and European banks in the United States for non-compliance with US sanctions and anti-corruption regimes have prompted many banks to put a lot more focus on ensuring compliance of their clients with these rules. In particular, US banks, but also other affected banks, are now requiring extensive representations and undertakings in credit agreements in that regard from their borrowers and related subsidiaries, including the requirement to comply with the US Department of Treasury’s Office of Foreign Asset Control (OFAC) regulations, regardless of whether the relevant borrowers and their affiliates are in fact active in the US market. This extraterritorial reach of US regimes, in particular, of the sanctions regime, creates legal issues under domestic German law. German foreign trade law contains an anti-boycott rule that prohibits German individuals and corporations from participating in a boycott if it is not a sanction applied by Germany, the European Union or the United Nations. Though for most US sanctions there are similar sanctions in Germany, the European Union or the Unite Nations, Cuba, for example, is not sanctioned by these bodies. Were a German national to undertake to comply with US sanctions on Cuba (included in the OFAC regulations), it would be in breach of the German anti-boycott statute. The breach would constitute an offence. This issue was typically not only raised by the borrowers but also by certain German banks if they formed part of the syndicate, as there was fear that the offence committed by the borrower could also have an impact on the German lenders. While this German ‘specialty’, which has a European equivalent with the Blocking Statute – Council Regulation (EC) No. 2271/96 – which prohibits compliance by European persons with certain US legislation (including the sanctions against Cuba, Iran and Libya) as this may be prejudicial to EU interests – has been a topic for discussions for some years now, the market (including foreign banks) has recognised that the matter needs to be addressed properly. In recent credit agreements, the relevant representations and undertakings are usually qualified such that they do not apply if the relevant member of the borrower’s group was otherwise in breach of applicable law. In addition, on the lenders’ side, syndicate members can opt out from being addressees of the relevant representations and undertakings to ensure that they do not breach applicable law when requiring the borrower to give these representations and undertakings.

The latest trend in relation to these more specific ‘compliance with laws’ representations and undertakings that banks require from their clients is compliance with anti-money laundering (and also anti-corruption) provisions. The focus has shifted a little towards this topic as several banks have been, and continue to be, investigated for alleged breaches of anti-money laundering laws.

In 2017, the German Federal Supreme Court shook up the lending market in Germany with two different decisions: one in relation to upstream security and one in relation to upfront fees for loans in general business terms and conditions.

After many years of uncertainty, the Federal Supreme Court decided that, when determining whether the provision of upstream security would result in a breach of capital maintenance rules, the situation of the company at the time of the creation of the security (and not at the time of enforcement) had to be examined. The Federal Supreme Court went on to say that when at the creation of the upstream security a compensation claim by the subsidiary against its parent was fully valuable, capital maintenance rules would not be affected. Many market participants have read the decision in a way that means, going forward, typical
limitation language (see Section IV) would no longer be necessary to ensure compliance with capital maintenance rules if the parent whose obligations are secured upstream was financially stable. However, certain other deliberations in the decision point to a much more conservative view and banks seem to have now largely accepted that borrowers require to continue to use limitation language in a similar manner as before the Federal Supreme Court decision, limiting enforcements to ensure compliance with capital maintenance at the time of enforcement.

In another ruling, the Federal Supreme Court held one-off upfront fees for loans invalid if agreed in general business conditions. As per the ruling, this does not only apply in relation to consumers but also to commercial undertakings. This ruling has unsettled market participants as typical upfront fees, such as arrangement and participating fees, which are desired by both banks and borrowers, could be at stake. Since that decision, both borrowers and lenders have regularly been collaborating to avoid or at least significantly reduce any invalidity risk using different methods, including the choice of foreign law for fee letters (which does not solve the problem in all circumstances), lenders offering alternative time-based remuneration elements to borrowers and borrowers proposing the upfront fees to the lenders when approaching the lenders. In contrast, the Federal Supreme Court has further confirmed its 2017 ruling with additional case law in relation to (invalid) upfront fees.

III TAX CONSIDERATIONS

For German tax-resident lenders, interest payments received under a loan are subject to corporate income tax, including solidarity surcharge thereon at an aggregate rate of 15.825 per cent plus trade tax (a tax levied by the different municipalities, which ranges from 7 per cent to approximately 18 per cent). Although Germany imposes a withholding tax of 26.375 per cent on certain categories of capital investment income, interest on ordinary loans is generally not subject to this withholding tax. Exceptions apply to hybrid loans (e.g., loans containing a profit participating component).

Lenders not tax-resident in Germany, in the absence of German withholding tax, are generally not subject to German taxes on interest payments made by German borrowers. There is, however, one important exception: if the loan is secured (directly or indirectly) by German-situs real estate, the foreign lender is required to file a tax return and pay taxes on the interest payments. To secure its tax claim in relation to foreign borrowers, German tax authorities can impose a respective withholding obligation on the borrower's interest payments. Most double tax treaties concluded with Germany, however, deny Germany the right to impose (withholding) taxes on such interest payments.

Typically, a customary German law loan document based on the LMA standard will contain standard LMA language (gross-up with the qualifying lender concept; tax indemnity provisions). Where the loan is secured by German-situs real estate, however, this language needs to be carefully rephrased to take care of the possible tax liability of a lender with respect to such interest payments and of the eventual withholding obligation of the borrower.

From a German tax perspective, interest payments are generally tax deductible (subject, however, to general interest deductibility limitations such as interest barrier rules). This also (and still) applies to interest payments on hybrid instruments where the lender’s jurisdiction treats the ‘interest’ payment as a tax-exempt dividend, whereas Germany treats the same payment as a tax-deductible ‘interest coupon’. Rather, these incongruences, as well as cases in which interest paid on a loan can be deducted in more than one jurisdiction, have become
part of the European anti-tax avoidance directives that have been adopted by the European Union and are now to be implemented by the Member States. German governmental officials have announced that it should be expected that Germany will enact respective legislation in the course of 2019 while draft legislation has not been published yet.

Germany currently does not levy any stamp or documentary taxes on loan and security documentation, or loan trading documentation (neither upon execution nor enforcement).

As regards the Foreign Account Tax Compliance Act (FATCA), financial institutions in Germany do not need to enter into a FATCA agreement with the Inland Revenue Service, but rather have certain reporting requirements as regards the German tax authorities, and regular corporate borrowers should usually not be affected. Nevertheless, it has become market practice to include the LMA language on FATCA withholding into the standardised LMA loan agreements, whereby Rider 3 (FATCA is a lender risk) is typically used.

IV CREDIT SUPPORT AND SUBORDINATION

German law provides for several types of security interests. The main distinction is between accessory and non-accessory security interests.

Accessory security interests, such as pledges over receivables or shares, and mortgages over real estate, can only exist in conjunction with the secured claim or claims. In other words, they automatically lapse as soon as the secured claim is finally discharged or even exchanged. In addition, accessory security interests can be created for the benefit of the creditor of the secured claim only. Therefore, an accessory security interest cannot be transferred without simultaneously assigning the secured claim. This creates certain legal challenges for trading secured loans (see Section VI).

By contrast, the existence and validity of non-accessory security interests is legally independent from the existence of any secured claims. The link between the security interest and the secured claims is created by means of a security purpose agreement. For non-accessory security interests, agency structures do not pose any particular problems, and the secured claims can easily be exchanged. Generally, non-accessory security interests, such as assignments of receivables, security transfers of title to movables or land charges, are preferred over accessory security interests.

If more than one security interest has been created with respect to the same collateral, the earlier security interest would be senior in rank to the later security interest as a matter of law as far as pledges and land charges are concerned, or the later encumbrance would not be valid if the grantor no longer holds the title to the collateral, such as in the case of a prior assignment or transfer for security purposes. The order of priorities can be amended by contractual arrangement, which is commonly done through intercreditor agreements in the case of transactions involving various groups of secured creditors.

Apart from certain procedural constraints, enforcement of security is subject to a number of limitations. In the case of upstream or cross-stream security, enforcement against the assets of the security-granting subsidiary is usually limited to protect the security grantor’s registered capital (based on a balance-sheet test) and sometimes also the liquidity of the security grantor, thereby shielding its management from potential personal liability, unless the loan proceeds have been made available to the security grantor (‘limitation language’, which will usually be addressed in German law legal opinions (see Section V)). For the statutory rules concerning the subordination of shareholder loans, see Section VII.
For certain security interests, the insolvency administrator may be entitled to control the enforcement process and retain a certain percentage of the enforcement proceeds for the benefit of the insolvency estate (haircut). German insolvency law also provides for a number of contestation rights that insolvency administrators frequently use to challenge transactions (including loan repayments or the creation of security) during certain suspect periods that can extend to up to 10 years prior to the filing for the opening of insolvency proceedings. German courts have given a very broad interpretation to a number of these contestation rights, and contestation rights have become a significant area of concern to lenders in any dealings with borrowers who experience – or might in the foreseeable future experience – economic difficulties.

V LEGAL RESERVATIONS AND OPINIONS PRACTICE

Legal opinions on German law-governed credit agreements contain various legal limitations or qualifications, some of which are similar to qualifications also made in other jurisdictions, such as limitations by applicable bankruptcy, insolvency, avoidance and other laws of general application to creditors, and principles of equity and good faith. Others are more specific to Germany and German law, such as the fact that longer-term agreements (such as credit agreements) may always be terminated for good cause, even if the contract provides that the agreement cannot be terminated during its agreed-upon term. German validity opinions will also mention that, under German law, any agreement to compound interest (and provisions having a similar result) will be held invalid by German courts.

More recently, the German Federal Court of Justice has held contractual clauses void that provide for an automatic termination of the contract or a right of the other party to terminate in the event of an insolvency of (or other insolvency-specific circumstances affecting) one party (insolvency-related termination clauses), unless these clauses correspond to specific statutory termination rights. Although this decision was rendered in connection with a long-term energy supply agreement, it is discussed and argued in legal literature whether this decision will also be applied to loan agreements and the typical ‘insolvency’ or ‘insolvency process’ events of default. Although there are good arguments why it should not, this matter will typically be addressed as a limitation in German validity and enforceability opinions, which will state that it cannot be ruled out that termination or draw-stop rights under a facility agreement cannot be validly exercised solely based on such insolvency-related termination clauses.

As regards the provision of guarantees and in rem security, German validity opinions will mention that the provision of guarantees or security by a German limited liability company, or a limited partnership with a limited liability company as general partner to secure obligations of its (direct or indirect) parent company and or any subsidiary of any of its direct or indirect parent (upstream or cross-stream guarantees and security), is subject to restrictions under German capital maintenance rules and under the doctrine of interferences jeopardising the subsidiary’s existence. In addition, the legal opinion is likely to mention that it cannot be ruled out that the guarantee or collateral granted might be seen as to have been granted in violation of the liquidity protection rule set out in Section 64(3) of the German Limited Liability Companies Act if an enforcement of the guarantee or security would result in the illiquidity of the German subsidiary. As far as the guarantee and the security to be provided is concerned, the relevant agreements will customarily provide for limitation language (as referred to in Section IV), which aims at limiting the enforceable...
amount to what is permissible – in particular, under the capital maintenance rules – but the legal opinion will note that specific modifications to the calculation of the balance sheet test, as are customarily required by the lenders, may render the upstream guarantee and security to be in breach of capital maintenance requirements.

‘Financial assistance’ is not generally prohibited in Germany, but insofar as German stock corporations are the target of an acquisition, the stock corporation must not provide any direct or indirect support to the acquisition of its shares. This prohibition also applies to subsidiaries of stock corporations. Although the law explicitly states that financial assistance is not prohibited for a stock corporation if it is a controlled company under a domination and profit and loss pooling agreement (DPLA), legal opinions will contain a qualification that this should only apply if the loss equalisation claim that is the legal consequence of a DPLA is fully valuable.

Finally, in addition to the general qualifications in relation to insolvency laws, legal opinions will contain specific qualifications regarding clawback risk if collateral is granted in situations of financial distress, in particular in restructurings.

Legal opinions in German loan transactions are usually provided by both parties’ counsels, with lenders’ counsel usually providing the validity and enforceability legal opinion in relation to the credit agreement, the security documents and the intercreditor agreement (if any), and with borrower’s counsel providing the capacity opinions for the borrower’s side (i.e., borrower, guarantors and security providers).

All opinions are usually addressed to, and may only be relied upon by, the original parties on the lenders’ side, namely original lenders, agents, mandated lead arrangers and book-runners. If the transaction is to be syndicated post-closing, the opinions are usually also addressed to, and may be relied upon by, the persons becoming lenders during the primary syndication of the credit agreement, provided that there is a long-stop date for the lenders becoming addressees (usually three or six months during which the primary syndication is usually completed).

Although the circle of addressees who are entitled to rely on legal opinions is limited, disclosure of legal opinions may also be made – on a strict non-reliance basis – to:
a any affiliates and advisers of the addressees to the extent they need to know the contents;
b any competent courts, or governmental, regulatory or supervisory authorities; and
c any potential (i.e., eligible) assignee, transferee or sub-participant so that the legal opinions may be made available for the purposes of loan trading.

Generally, courts in Germany will uphold the choice of foreign law governing a credit agreement and also enforce foreign court judgments. The recognition of the choice of law is subject to the German conflicts of law principles that would prevent the foreign law chosen from being recognised. Under these conflicts of law principles, the choice of foreign law would not be upheld to the extent, for example, that the result of the application would violate fundamental principles of German law, or be in conflict with internationally applicable overriding mandatory provisions of German or foreign law within the meaning of Article 9 of Council Regulation (EC) No. 593/2008 on the law applicable to contractual obligations. Or, if the relevant factual circumstances are only connected to a particular jurisdiction or jurisdictions of Member States of the European Union, German courts would apply the mandatory provisions of that jurisdiction or EU law irrespective of the choice of law of any other jurisdiction.
Any choice of law clause relating to non-contractual obligations, as is typically provided for in the governing law clause of LMA loan agreements, will be recognised and applied by the courts in Germany subject to Article 14 of the Council Regulation (EC) No. 864/2007, and subject to German public policy.

In the European context, a court decision rendered in an EU Member State will be recognised in Germany, and a court decision rendered in another Member State and enforceable in that Member State will be enforced in Germany without any declaration of enforceability by a German court being required. Each case is subject to the provisions of 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, and the provisions of the German Act on Civil Procedure.

A final judgment of a Swiss, Norwegian or Icelandic court for a finite sum of money will be recognised and enforced in Germany subject to the Convention dated 30 October 2007 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (the Lugano Convention), as well as the applicable provisions of the German Act on Civil Procedure.

For court decisions from other non-EU Member States and states in which the Lugano Convention on enforcement does not apply, foreign court decisions are generally enforced following an action or suit brought in accordance with the rules of the German Act on Civil Procedure for an enforcement judgment. German courts will generally order an enforcement judgment without review of the merits of the foreign judgment. However, the German court would examine whether the foreign judgment is legally effective and final, whether there is any statutory or judicial impediment to enforcement, and whether there are any defences (within the meaning of German Act on Civil Procedure) that have arisen after the foreign judgment became legally effective and final. In particular, an enforcement judgment will not be rendered if:

- the courts of the state to which the foreign court belongs are not competent pursuant to German law;
- the defendant, who has not participated in the proceedings and raises this defence, has not been properly served the documents initiating the proceedings or not served in a timely manner so that it was in a position to defend itself;
- the judgment is inconsistent with a judgment rendered in Germany or with an earlier foreign judgment subject to recognition, or if the proceedings on which it is based are inconsistent with a proceeding in Germany that is currently pending;
- the recognition of the judgment would give rise to a result that is manifestly irreconcilable with basic principles of German law; or
- if in the jurisdiction of the relevant foreign court, a German judgment would not be recognised on generally equivalent conditions (reciprocity).

VI  LOAN TRADING

In Germany, participations in loans are traded as in many other jurisdictions. In most cases, and certainly where the underlying loan agreements are documented under LMA standards, the secondary trading documentation is used based on the templates prepared by the LMA. In contrast to practice in the United Kingdom, a novation is normally not used as a method of transferring the participation of German law-governed loans, particularly if the loan is secured, as a novation would invalidate any pledges (or any other accessory security
instruments) created under German law. This is because accessory security instruments are cancelled by operation of law if the secured claims cease to exist (see Section IV). In lieu of a novation, an assignment and transfer by way of an assumption of contract is used in Germany, which leads to a transfer of the contractual position as a whole, with all of its rights and obligations. In practice, the same result is achieved as with a novation. Besides this, ordinary assignments and sub-participations are also used as methods of transferring loan receivables (or the underlying risk).

Secondary purchasers can obtain the benefit of the security granted to the initial lenders in different ways, but typically in the syndicated lending market as follows.

As set out in Section IV, the key feature of securities under German law is the distinction between accessory security rights (dependent on the claim being secured) and non-accessory security rights (which remain in place even if the secured obligation ceases to exist). This distinction also plays an important role in the transfer of security if the loan is transferred. In addition, non-accessory security can be granted to a security agent by transferring to it the assets used as collateral. In syndicated loans, the non-accessory security will usually be held by a security agent and not transferred when a share in the loan is transferred. What is transferred is the claim against the security agent for a pro rata share in any proceeds from the enforcement of the non-accessory security. Accessory security, in contrast, depends on a secured claim and will transfer to an acquirer of a secured claim by operation of law once the secured claim is transferred. A pledge (and any other accessory security right) can only be created to the extent the pledgee is the creditor of the secured claim. This means that a security agent cannot receive accessory security in lieu of the lenders. The security agent can only receive a pledge that secures the obligations owed to it. Therefore, any pledge received by the security agent would not secure the claims of the (other) lenders. A particular problem arises in connection with accessory security if undrawn commitments are transferred, as the security cannot transfer to the purchaser in the wake of a secured claim. This is a particular issue for secured facilities in primary syndication as, at that time, the facilities are often still undrawn. Legal practice in the lending market has developed two ‘solutions’ to enable the security agent to also hold accessory security and to enable the transfer of shares in the facility agreement followed by an automatic transfer of security without a requirement for the security provider to regrant the pledge or pledges, even if the facilities are still undrawn: the parallel debt and the future pledgee concepts. Both concepts, although widely used in German secured lending, have not yet been confirmed by German courts as valid. In fact, it is doubtful whether they do operate as designed.

The security agent will usually be the only person entitled to enforce any security (the non-accessory security that is granted to it and the accessory security that is granted to the lenders), but the enforcement of this is usually delegated to the security agent by the lenders. In the documentation, lenders typically waive their right to enforce and individually delegate the exercise of that right to the security agent. As regards guarantees, this is much simpler. The guarantees are abstract (non-accessory) and made to any person who is a lender at the time the guarantee is drawn. Therefore, there is no transfer mechanism required or provided for. This is also one of the main reasons why loan agreements are secured by guarantees and not by the statutory German instrument suretyship, which is an accessory instrument.
VII OTHER ISSUES

Another issue to be considered by lenders in connection with German loan transactions is that, where lenders hold participations in a borrower (whether directly or indirectly) and those participations exceed 10 per cent of the (liable) share capital of the borrower, the loans granted by such lenders will, in insolvency, be subject to equitable subordination. In other words, they will be treated as shareholder loans and not rank pari passu with the other loan debt. Security created for equitably subordinated claims is not enforceable in an insolvency of the borrower. Also, in such situations, any payments received within the year before a filing for insolvency proceedings are subject to clawback by the insolvency administrator. Therefore, lenders who, either directly or through affiliated companies, are engaged in participating in companies should carefully note the shareholder structure of any borrowers they are lending to, to see if they or their affiliates might be invested in them.

VIII OUTLOOK AND CONCLUSIONS

The authors consider it likely that competition within and among the different debt products will continue for some time, and borrowers will make use of this beneficial market environment until the excess liquidity turns away from debt products or dries up.
Chapter 9

HONG KONG

Peter Lake

I OVERVIEW

Hong Kong has an active bilateral loan market.

Syndicated lending is generally documented using the facility agreement forms prepared by the Asia Pacific Loan Market Association.

The main providers of finance are the Hong Kong-regulated financial institutions that have been authorised under the Banking Ordinance (Chapter 155 of the Laws of Hong Kong) as ‘authorised institutions’ to hold banking licences. Funds and private equity houses are more visible in bilateral bridge or other short-term bespoke financing arrangements.

Three years of decreasing syndicated loan volumes in the Asia Pacific (excluding Japan) came to an end in 2018, with an uplift of 8.9 per cent year-on-year. However, financings for mergers and acquisitions activity in the region continued to fall, totalling US$35.3 billion in 2018. Less fresh money was sought by borrowers due to worries over the trade war escalating and the lack of pace in the global economy – refinancings and amend-and-extend activity bolstered the loan volume by comprising 56 per cent.2

The US-dollar amount contributed by Hong Kong to the total loan volume in the Asia Pacific (excluding Japan) decreased by nearly 5 per cent compared with 2017, but it made up 22.8 per cent of the total loan volume in the region. Key amend-and-extend transactions for Hong Kong included a combination of an amend-and-extend and a dividend recapitalisation for Belle International Holdings Ltd worth US$3.69 billion – the biggest of its kind in the year for Hong Kong.3

II LEGAL AND REGULATORY DEVELOPMENTS

i Companies Ordinance

On 3 March 2014, a restatement of the Companies Ordinance (Chapter 622 of the Laws of Hong Kong) was brought into effect. Of particular note to lenders are the following changes:

a a reduction of the period to register charges with the Companies Registry. This period was reduced from five weeks to one month. The list of registrable charges was also amended and the underlying instrument of charge is now publicly available;

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1 Peter Lake is a partner at Slaughter and May. The author would like to thank his colleagues Mike Ringer and Gabrielle Pereira for their assistance in preparing this chapter.


3 ibid.
b financial assistance no longer resulting in underlying transactions becoming voidable (although it remains a criminal offence for the companies giving financial assistance). The exemptions from financial assistance have been broadened;
c changes to the terminology for financial statements;
d the abolition of the concepts of nominal share capital and premium, and of authorised share capital;
e the retirement of the memorandum of association; and
f an additional procedure for Hong Kong-incorporated companies to execute documents by way of deed but without affixing the common seal.

Lenders have expressed concern with respect to the clarification under the Companies Ordinance that charges over bank accounts are not charges over book debts (and so are not registrable under that head of registration). Lenders receiving security over bank accounts wish to protect their position by ensuring the bank account charge is registered at Companies Registry. In light of bank account charges not being registrable per se, the usual technique to register a bank account charge is to notify the Companies Registry that the bank account charge may be construed as a floating charge (as all floating charges are registrable under a separate head of registration).

With underlying instruments of charge now publicly available, the Companies Registry has stated it is now ‘more important than ever’ for lenders to make enquiries and search the Companies Register for charges. Although there is no Hong Kong case law on this point, the availability of the underlying instrument of charge will likely impact upon the issue of priorities between competing charge instruments.

ii Foreign Account Tax Compliance Act
Hong Kong has implemented the Foreign Account Tax Compliance Act (FATCA) Model 2 intergovernmental agreement. Although there remains variance in terms, as far as borrower risk is concerned, the market has moved towards a balanced position (namely that FATCA withholding is lender risk).

iii Basel III
Capital adequacy ratio
The Hong Kong Monetary Authority (HKMA) has issued rules (the Banking (Capital) Rules) under the Banking Ordinance (Chapter 155L of the Laws of Hong Kong), which prescribe in detail how the capital adequacy of locally incorporated authorised institutions should be calculated. These rules are based on the Basel III recommendations (which were implemented in Hong Kong on 1 January 2013).

A Hong Kong-incorporated authorised institution is required under the Banking (Capital) Rules to maintain a Common Equity Tier 1 capital ratio of at least 4.5 per cent, a Tier 1 capital ratio of at least 6 per cent and a total capital ratio of 8 per cent. Branches of foreign banks are not subject to this requirement but, based on the HKMA’s past practice of generally requiring any foreign bank that wishes to establish a branch in Hong Kong to maintain a capital adequacy ratio of at least 8 per cent, it is likely that the HKMA will continue to require foreign banks to meet the three minimum risk-weighted capital ratios.
**Capital buffers**

In accordance with the Basel III recommendations, the HKMA may require a Hong Kong-incorporated authorised institution to have further capital buffers to cater for risks and uncertainties that are not already captured by the three minimum risk-weighted capital ratios that comprise the capital adequacy ratio. The HKMA has implemented the following capital buffers: the capital conservation buffer, the countercyclical capital buffer and (for domestic systemically important banks (D-SIBs)) the higher loss absorbency requirement.

The capital conservation buffer has been phased in equal annual increments and increased from 1.875 per cent for 2018 to its upper level (provided for under the Banking (Capital) Rules), 2.5 per cent, for 2019.

The level of the countercyclical capital buffer is determined by the HKMA’s analysis on whether there is excess aggregate credit growth associated with a build-up of system-wide risk in Hong Kong. On 10 January 2018, the HKMA announced that the countercyclical capital buffer would increase to 2.5 per cent with effect from 1 January 2019. This is in accordance with the Basel III phase-in arrangement, which became fully effective as of 1 January 2019 and sets a final maximum of 2.5 per cent for 2019. The HKMA regard a continued build-up of the buffer as appropriate given the risks associated with recent continued credit and property market conditions and external political uncertainties.

The higher loss absorbency requirement applies only to D-SIBs. It is an extension of the capital conservation buffer. On 21 December 2018, the HKMA announced that Hong Kong’s list of D-SIBs remains unchanged, covering six banks. The six D-SIBs are: The Hongkong and Shanghai Banking Corporation Limited, Bank of China (Hong Kong) Limited, Hang Seng Bank Limited, Standard Chartered Bank (Hong Kong) Limited, The Bank of East Asia, and the Industrial and Commercial Bank of China (Asia) Limited.

If a Hong Kong-incorporated authorised institution’s capital level erodes to a level falling within the capital conservation buffer zone, the countercyclical capital buffer zone or, for a D-SIB, the higher loss absorbency buffer zone, restraints will be imposed on that institution’s distributions. A Hong Kong-incorporated authorised institution is expected to have a discussion with the HKMA if it anticipates that any of its capital levels will fall close to the buffer zones.

**Loss-absorbing capacity rules**

The Financial Institutions (Resolution) Ordinance (Chapter 628 of the Laws of Hong Kong) covers resolution, including bank resolution. On 14 December 2018, the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules were issued and came into operation. They enable the HKMA to prescribe loss-absorbing capacity (LAC) requirements for ‘within-scope’ financial institutions that are Hong Kong-incorporated authorised institutions, and for their Hong Kong-incorporated holding companies or affiliated operational entities. Not all Hong Kong-incorporated authorised institutions will be classified as ‘within-scope’ – meaning that not all of them will be subject to LAC requirements. The LAC consolidation group may differ from the regulatory capital consolidation group. The rules set out how to calculate LAC leverage ratios (both external and internal LAC, and under a solo, solo-consolidated and consolidated basis), capital component ratios and resolution component ratios (which will often be the same as the related capital component ratio). External LAC will at a minimum be the sum of an authorised institution’s capital component ratio and its resolution component ratio. Internal LAC will be set at a fraction of the external LAC (likely 75 per cent in most cases). There is a requirement for at
least a specified portion (likely one-third) of the LAC to be in the form of LAC debt, since LAC debt (unlike LAC equity) is not at risk of depletion before bank failure and so provides a fixed quantity of financial resources that can support an orderly resolution. The rules also cover disclosure requirements in relation to LAC and deductions for holding non-capital LAC liabilities.

Capital that counts towards meeting the regulatory capital requirement (i.e., hard requirements, ignoring the ‘softer’ capital buffers) will generally count towards meeting a LAC requirement. This means that the new additional burden for a ‘within-scope’ Hong Kong-incorporated authorised institution will likely be the resolution component ratio.

iv Sanctions and anti-corruption

Hong Kong banks must comply with the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Chapter 615 of the Laws of Hong Kong), which in particular sets out specific customer due diligence and record-keeping requirements that must be followed. In March 2015, the HKMA issued the guidance paper ‘Anti-Money Laundering Controls over Tax Evasion’. The guidance paper is in addition to the HKMA’s ‘Guideline on Anti-Money Laundering and Counter-Terrorist Financing (for Authorized Institutions)’, which was modified in March 2018 to reflect enhancements made in the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) (Amendment) Ordinance 2018 and subsequently updated in October 2018. Both the guidance paper and the Guideline assist authorised institutions in complying with the Anti-Money Laundering and Counter-Terrorist Financing Ordinance.

Hong Kong-authorised institutions are required to check and report against the list of names issued under the US President’s Executive Order 13224 and the list of names published under Hong Kong’s United Nations (Anti-Terrorism Measures) Ordinance (Chapter 575 of the Laws of Hong Kong) (which is updated to reflect changes to the list of specified terrorists and terrorist associations designated by the United Nations Security Council).

Hong Kong has a separate enforcement agency, the Independent Commission Against Corruption, to counter corruption. Its main focus is on preventing bribery (in both the public and private sectors).

v Benchmarks

The Hong Kong Interbank Offered Rate (HIBOR) is available for borrowings in Hong Kong dollars and yuan (although the majority of offshore yuan-denominated loans do not use the HIBOR in respect of interest calculations). The HKMA issued a statutory guideline ‘Code of Conduct for Benchmark Submitters’, which came into effect on 3 May 2013. The guideline forms part of the HKMA’s Supervisory Policy Manual.

Subject to consultation (launched in March 2019), the Treasury Market Association (TMA) has proposed to adopt the Hong Kong Dollar Overnight Index Average (HONIA) as the fall-back alternative reference rate (ARR) to HIBOR. This follows the recommendation of the Financial Stability Board (FSB) to identify an ARR to HIBOR. Notwithstanding this, the TMA see it desirable and necessary for HIBOR to remain (unlike the UK Financial Conduct Authority’s approach to the London Interbank Offered Rate). It remains to be seen whether the Hong Kong loans market will move from HIBOR to HONIA (or a forward-looking rate related to HONIA).
Banking resolution

EU Bank Recovery and Resolution Directive

With the implementation of Article 55 of the EU Bank Recovery and Resolution Directive (2014/59/EU), EU-based lenders typically require loan facilities that are governed by Hong Kong law to include contractual recognition of bail-in – whereby non-EU entities acknowledge that EU lenders may be subject to bail-in powers under that EU directive. The relevant language is usually based on the bail-in template language prepared by the Loan Market Association.

Hong Kong Financial Institutions (Resolution) Ordinance

Hong Kong’s Financial Institutions (Resolution) Ordinance came into force on 7 July 2017 and is designed to meet international standards set by the FSB. In due course, it is likely that contractual recognition of bail-in for non-Hong Kong law contracts will be required. The market language will no doubt closely follow the Loan Market Association’s bail-in template language. On 7 July 2017, the HKMA issued three Codes of Practice: ‘Resolution Planning – Core Information Requirements’, ‘Operational Independence of the Monetary Authority as Resolution Authority’ and ‘The HKMA’s Approach to Resolution Planning’.

The Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules (Chapter 628B) set out detailed LAC rules for authorised institutions. The rules are designed to be aligned with the international standards on LAC set by the FSB in its ‘Total Loss-absorbing Capacity Term Sheet’. On 20 March 2019, the HKMA issued a new related Code of Practice: ‘Resolution Planning – LAC Requirements’.

Insolvency regime

Hong Kong’s insolvency regime remains creditor-friendly with no specific debtor resolution regime in place.

Amendments to the Companies (Winding Up and Miscellaneous Provisions) Ordinance 2016 (Chapter 32 of the Laws of Hong Kong) came into force on 13 February 2017. The amendments seek to enhance creditor protection, streamline the winding-up process and strengthen regulation under the winding-up regime.

The amendments introduce new provisions to empower the court, upon the application of the liquidator, to set aside ‘transactions at an undervalue’ entered into within five years before commencement of the winding-up. The amendments also clarify existing provisions relating to transactions that are ‘unfair preferences’ entered into within six months (or, for a person connected to the company, two years) before the winding-up. For both provisions, for them to apply, the court must be satisfied that the company is unable to pay its debts at the time the transaction is made, or the company becomes unable to pay its debt as a consequence of the transaction.

The meaning of ‘transaction at an undervalue’ is defined in the new Section 265E of the Companies (Winding Up and Miscellaneous Provisions) Ordinance 2016. A company enters into a transaction with a person at an undervalue if (1) the company makes a gift to that person, or otherwise enters into a transaction with that person on terms that provide for the company to receive no consideration; or (2) the company enters into a transaction with that person for a consideration the value of which, in money or money’s worth, is significantly less than the value, in money or money’s worth, of the consideration provided by the company.
When setting aside such transactions, the court may make an order as it thinks fit to restore the position to what it would have been had the company not entered into these transactions.

III TAX CONSIDERATIONS

The Hong Kong tax regime includes three separate types of income tax – property tax, salaries tax and profits tax. Of these, profits tax is most relevant to lenders.

Hong Kong does not have a separate capital gains tax regime.

i Profits tax

Hong Kong adopts a territorial source principle of taxation.

Under the Inland Revenue Ordinance (IRO) (Chapter 112 of the Laws of Hong Kong), profits tax is charged on a person carrying on a trade, profession or business in Hong Kong; and in respect of income profits (excluding capital gains profits) arising in or derived from Hong Kong from that trade, profession or business.

The rate of profits tax for corporations is 8.25 per cent on profits up to HK$2 million and 16.5 per cent on the remainder for the year of assessment commencing 1 April 2019 (unchanged from the rates for the year of assessment commencing 1 April 2018).

Carrying on a trade, profession or business in Hong Kong

A low threshold is required to fall within the scope of carrying on a trade, profession or business in Hong Kong. The activity of depositing may, for example, be sufficient to constitute a business.

Income arising in or derived from Hong Kong

If the above test – of carrying on a trade, profession or business in Hong Kong – is satisfied, profits tax will (subject to exemptions) be chargeable if the income arises in or is derived from Hong Kong.

This is a factual issue, which is determined by looking at what the taxpayer has done to earn the relevant profit. A test often applied in difficult cases is where the operations take place from which the profits in substance arise. The place where a taxpayer’s profits arise is not necessarily the place where he or she carries on business.

Inland Revenue Department guidelines and case law assist in determining the locality where income arises, or where it is derived from.

Because of the difficulties in assessing the locality of interest and related fee income received by financial institutions, the Inland Revenue Department issued Departmental Interpretation and Practice Notes No. 21: Locality of Profits (revised July 2012), setting out the Inland Revenue Department’s current practice.

A modified extract from the practice note on the tax treatment of interest from loans is set out below.
### Types of interest incomes from loans

<table>
<thead>
<tr>
<th>Types of interest incomes from loans</th>
<th>Tax treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Offshore loans initiated, negotiated, approved and documented by an associated party outside Hong Kong and funded outside Hong Kong (i.e., funds raised and loaned direct to the borrower by a non-resident; for example, head office, branch, or subsidiary) albeit through or in the name of the Hong Kong institution.</td>
<td>100 per cent non-taxable</td>
</tr>
<tr>
<td>Offshore loans initiated, etc., by the Hong Kong institution and funded by it in or from Hong Kong.</td>
<td>100 per cent taxable</td>
</tr>
<tr>
<td>Offshore loans initiated, etc., by an associated party outside Hong Kong but funded by the Hong Kong institution.</td>
<td>50 per cent taxable</td>
</tr>
<tr>
<td>Offshore loans initiated, etc., by a Hong Kong institution but funded by offshore associates. It is considered that this category only applies to start-up positions where the Hong Kong institution has yet to establish a market presence.</td>
<td>50 per cent taxable</td>
</tr>
</tbody>
</table>

**Note on ‘funding’.
For claims concerning loans funded by offshore associates, two essential requirements will have to be satisfied, namely:

a. that the Hong Kong institution does not have the authority to seek its own source of funds in respect of the loans; and

b. there must be documentary evidence to show that funds have been directly provided by an offshore associate even though such funds may have been routed through another vehicle in Hong Kong. In other words, arbitrary funding by another group vehicle in Hong Kong will not satisfy this requirement.

**Note on ‘initiation’.

‘Initiation’ refers to the efforts exerted in obtaining the particular business including solicitation, negotiation and structuring of the loans. The financial institution must be able to substantiate that the mandate or invitation to participate was secured as a direct result of the activities of an associated party outside Hong Kong for an offshore claim to succeed.

Participation, commitment and other fees will follow the tax treatment accorded to the related loan under the above.

### Deductibility of interest paid by borrowers

Payments of interest by a Hong Kong corporate that are incurred in the production of its chargeable profits are generally deductible, subject to certain anti-avoidance provisions. The anti-avoidance provisions seek to deal with the lack of symmetry in tax treatment on interest received (as the starting point is that interest income is not taxable, though interest expenses are tax-deductible).

#### Double taxation agreements

As at 2 January 2019, Hong Kong had comprehensive double taxation agreements with Austria, Belarus, Belgium, Brunei, Canada, the Czech Republic, Finland, France, Guernsey, Hungary, Indonesia, Ireland, Italy, Japan, Jersey, Korea, Kuwait, Latvia, Liechtenstein, Luxembourg, mainland China, Malaysia, Malta, Mexico, the Netherlands, New Zealand, Pakistan, Portugal, Qatar, Romania, Russia, Saudi Arabia, South Africa, Spain, Switzerland, Thailand, the United Arab Emirates, the United Kingdom and Vietnam.

The terms set out in double taxation agreements take precedence over the other provisions of the IRO.
iii Stamp duty

Hong Kong stamp duty is chargeable on certain transactions (including the issue of certain bearer instruments) but is not chargeable on the entering into or transfer of loan facility agreements (on the basis that a transfer under a loan facility typically will not require registration in a register located in Hong Kong).

Lenders may, therefore, transfer their commitments and loans by way of either assignment or novation.

IV CREDIT SUPPORT AND SUBORDINATION

i Security

Common methods of taking security in Hong Kong include the following:

a mortgages:

• which involve the mortgagor transferring the property to the mortgagee, with the mortgagor having an equitable right to have the property returned upon paying off the debts to which the mortgage relates. Although it may be used for a variety of types of properties, it is more commonly used for real property. The Conveyancing and Property Ordinance (Chapter 219 of the Laws of Hong Kong) sets up a statutory overlay in respect of Hong Kong real property, so that any mortgage of a legal estate in Hong Kong real property may only be effected at law by a deed expressed to be a legal charge (which is a creature of statute);

b charges or assignments by way of security:

• Hong Kong recognises both fixed and floating charges, with fixed charges taking priority over floating charges where the chargee has had no notice of negative pledge prohibitions. Charges may be granted over future property;

• charges over choses in action are usually drafted as an assignment by way of security – although the courts make little distinction between (1) charges and (2) assignments by way of security;

c pledges (by way of transfer of possession of tangible property); and

d liens (by way of the lienholder retaining possession of tangible property).

The typical ways of taking security over real estate; tangible movable property; shares and financial instruments; contractual rights and receivables; and intellectual property (IP) rights are described below.

Real estate

Security over Hong Kong real estate is often given by way of a fixed legal charge (whereas security over choses in action related to the property is given by way of an assignment). Although lenders are not required to adopt any specific mortgage form, The Hong Kong Mortgage Corporation Limited has introduced a set of standard form model mortgage documents in respect of residential properties.

Security granted over a registrable interest in land must be registered with the Land Registry.
**Tangible movable property**

Security over tangible movable property is often given by way of a fixed or floating charge:

- **Fixed charge**: created over a particular identified property (which may include future property). The chargee's consent is required for the chargor to dispose of the property free from the charge. If the chargor defaults, the chargee may enforce the charge by selling the property. Typically, the chargee will appoint a third-party receiver to enforce the charge to protect the chargee from potential liability arising from enforcement.

- **Floating charge**: similar to a fixed charge but created over a moving class of assets (such as stock), which may change on occasion. Unlike a fixed charge, the chargor may dispose of the charged assets and carry on its business as usual until an event (such as acceleration under an event of default) occurs that crystallises the floating charge into a fixed charge. Floating charges rank behind fixed charges granted (before floating charge crystallisation) over the same property.

To reduce the risk of tangible charged property being sold to a bona fide purchaser of the legal estate without notice of the charge, where possible, plaques should be attached to the charged property to give notice to third parties of the existence of the charge.

**Shares and financial instruments**

Security over shares and financial instruments is often given by way of a fixed or floating charge.

The charging language used will depend upon whether the shares are held directly in certificated form or indirectly via a nominee or custodian.

In the case of a charge over Hong Kong shares held directly in certificated form, the chargor will transfer the share certificate to the chargee and execute a blank form of instrument of transfer and a blank sale contract note, which the chargee may complete upon enforcement and use to transfer the shares to a third party. The chargee may also ask the chargor to arrange for the signature – by the directors of the underlying company whose shares are charged – of certain undated board resolutions and undated resignation letters of directors, with authority for the chargee to complete these documents upon enforcement.

Unless the share charge extends to a charge over dividends, notice is typically not sent to the company whose shares are charged as this will not affect priorities (Section 634 of the Companies Ordinance states that no notice of trust may be entered in a Hong Kong company’s register of members). This means that, under a share charge, a chargee is exposed to the risk of a chargor transferring legal title to the charged shares to a bona fide purchaser without notice. Such a bona fide purchaser without notice would likely take the shares free of the charge. Although the chargee holds the share certificate, the chargor may apply to the company for a new share certificate on the basis that the previous share certificate has been lost or destroyed. Although there is a court process under which a ‘stop notice’ may be served by the chargee on the underlying company whose shares are charged, requiring the underlying company to give notice to the chargee if the chargor attempts to transfer the shares, this process is rarely used.

When taking security over shares and financial instruments, the terms governing the underlying shares or instrument must be checked to ensure there are no provisions prohibiting transfer (and, if there are, those provisions should be amended).

In the case of a charge over shares held indirectly via a nominee or custodian, the charging language is more similar to that used for contractual rights and receivables (described below). Notice of the share charge should be sent to the nominee or custodian to preserve priority.
For other financial instruments, notice of a charge should usually be given to preserve priority (with the notice given to the person who either owns the instrument on behalf of the chargor, or to the payor under the instrument, as applicable).

**Contractual rights and receivables**

Security over contractual rights and receivables is usually drafted in the form of an assignment by way of security. Courts make little distinction between a fixed charge and an assignment by way of security.

As for shares and other instruments, the terms of the contractual rights and receivables should be reviewed to ensure there are no provisions prohibiting transfer (and, if there are, those provisions should be amended).

Notice of charge should be given to the debtor or payor to which the contractual rights and receivables relate to preserve priority.

**IP rights**

Hong Kong has specific registries for patents, trademarks and designs, although there is no registry for copyright.

Security is usually taken in the form of a mortgage, charge or assignment, by way of security.

Security over registered IP should be registered at the Hong Kong Patents Registry, the Trade Marks Registry or the Designs Registry. If the security is not registered, it is ineffective against certain acquirers who acquire the IP without notice of the security. There is no legal requirement to make the registrations within a specified time, although late registration may impact upon damages claims as well as priority and perfection against third parties.

**Formalities**

**Hong Kong real estate – the Land Registry**

Security over Hong Kong real estate (if registrable) must be registered with the Land Registry to protect its priority. If the document is registered within one month of execution, it takes priority from the date of execution. Late registrations will take priority from the date of registration.

**The Companies Registry**

Where the grantor is a Hong Kong-incorporated company; or a non-Hong Kong company that is registered at the Companies Registry (usually required by reason of having a place of business in Hong Kong) that is granting security over Hong Kong property, specified types of securities must be registered with the Companies Registry within one month of execution. Otherwise, the security will be void against any creditor or liquidator, and the chargor company (and certain of its officers) will commit an offence.

The following are the more common types of securities that must be registered, including over:

- any property where the security granted is a floating charge;
- chattels;
- land;
- book debts (but excluding bank accounts);
- ships;
f. aircraft; and

g. goodwill, patents, trademarks and copyright.

The full list of securities that must be registered is set out in Section 334 of the Companies Ordinance.

Although security over a bank account is not registrable as a book debt, it will be registrable if the security is a floating charge. The question of characterisation of security is a matter of both form and substance. A factor to take into account will be the nature of the dealings and interactions between the chargor and chargee.

Registration requirements also apply where an asset is acquired that is subject to security.

**IP registers**

Security over patents, registered designs and trademarks are subject to specific registrations:

- **a** security over patents and registered designs must be recorded at the Hong Kong Patents Registry by filing Form P19 or at the Designs Registry by filing Form D5; and
- **b** security over a registered trademark must be registered at the Trade Marks Registry by filing Form T10.

An unregistered security interest over a registered patent, design or trademark is ineffective against certain acquirers who did not have notice of the security interest at the time of the acquisition.

**Aircraft**

Although there is no statutory duty, market practice is to notify the Civil Aviation Department in Hong Kong of the security interest, and to include chargee details on the nameplate of the aircraft to give notice of the security interest to third parties.

**Ships**

Security over ships is usually by way of mortgage. A mortgage over a Hong Kong-registered ship must be in a prescribed form and registered with the Hong Kong Shipping Registry. Priority is accorded from the time of registration.

**ii Guarantees and other forms of credit support**

Guarantees are commonly used in Hong Kong as a form of credit enhancement. Market documentation prepared by the Asia Pacific Loan Market Association includes loan facility agreements with integrated guarantee provisions.

Other credit support techniques that may be used include sale and leasebacks, transfer of collateral with an obligation to return the same (or equivalent) collateral, disposal of receivables with recourse remaining against the transferor, retention of title arrangements and contractual set-off arrangements.

Negative pledge undertakings are usually included in loan facility agreements. Breach by a borrower of a negative pledge entitles the lender to bring a damages claim as an unsecured creditor, but breach is unlikely to disturb the security granted in favour of a bona fide third party created in breach of the negative pledge.
iii Priorities and subordination

Subordination of debts

A lender may commonly seek subordination of debt owed by the borrower to creditor shareholders, so that the lender’s loan ranks in priority to the creditor shareholders’ loans. Such subordination is effected by way of contract, often by way of a deed of subordination between the borrower, the lender and the creditor shareholders.

Structural subordination is also permissible.

Priority of competing security interests

Priority is a complex matter that depends upon the particular facts and the relevant registrations (if any).

A common priority concern arises where a company grants security by way of two fixed charges over the same debt chose in action to two creditors. The starting point under common law is that the creditor who gives notice first to the debtor takes priority over the other creditor. If that fixed charge is registrable at the Companies Registry, to preserve priority the fixed charge must be registered within the required period of one month after execution. The Companies Ordinance requires that the instrument of charge must be registered in full. The text of the instrument of charge is therefore available to the public for a small fee.

Although it is unclear how these changes under the Companies Ordinance legislation affect the doctrine of notice, it is expected that registration of an instrument of charge will likely give rise to constructive notice of all the terms in the charge instrument – including negative pledge clauses – on the part of those who may reasonably be expected to search the Companies Registry, including banks, financiers and relevant professionals. It would appear that, for example, where a company grants a charge over a debt chose in action to a ‘first financial institution’ and then subsequently grants a charge over the same debt chose in action to a ‘second financial institution’, the first financial institution may take priority if the second financial institution would have been aware of the first financial institution’s interest had it searched the Companies Registry (regardless of whether the first financial institution has given notice to the debtor). In a similar way, negative pledges in floating charges may now bind later financial institutions that have a fixed charge interest in the same asset.

V LEGAL RESERVATIONS AND OPINIONS PRACTICE

Legal limitations on the validity or enforceability of lending and secured arrangements are described below.

If lenders (including via their agents) are put on notice that a borrower may not have properly convened and held the board meeting that authorised the relevant loan and security documents, the court may find that the documents do not bind the company. Care needs to be taken by lenders’ counsel that there are no irregularities that would so put lenders on notice. A particular case (Moulin Global Eyecare Holdings [2010] 1 HKC 90) where the courts found a lender had notice of irregularities, involved the lender’s counsel preparing draft board minutes and (as requested by the borrower) including in those minutes – prepared prior to the meeting – the list of specified directors of the borrower-listed company who were to attend the meeting. The specified directors were all connected to the controlling shareholder family, and none of the five non-executive directors (including three independent non-executive
directors) were included in the list. In the circumstances, which included there being little
time to give notice of the meeting to all directors, the court found that the loan and related
security documents did not bind the borrower-listed company.

Previous legal opinions concerned with financial assistance, leading to loans and
security being unenforceable, no longer apply for documentation entered into on or after
3 March 2014, when Hong Kong’s consolidated Companies Ordinance legislation came
into effect. Financial assistance remains an offence, and so remains a concern for subsidiary
guarantors and subsidiary security providers.

The way in which a non-Hong Kong corporate may execute Hong Kong law-governed
deeds (such as charges) is more restrictive than most common law jurisdictions. If execution
is not by way of affixation of a common seal or under a power of attorney that is valid in
the corporate’s place of incorporation, a reservation may be made in a legal opinion. As of
3 March 2014, the procedure for a Hong Kong-incorporated company to execute a Hong
Kong law-governed deed has been relaxed, but the relaxation does not apply to non-Hong
Kong corporates.

Although there is no binding Hong Kong case law in this area, Hong Kong practice
is to follow the UK Mercury\(^5\) case for the steps to take when executing a deed. If signature
pages are executed as a deed and the executed signature pages are later attached to the rest of
a document expressed to be a deed and governed by Hong Kong law, a reservation may be
made in a legal opinion.

Hong Kong law follows the doctrine of absolute Crown immunity (for the People’s
Republic of China but excluding Hong Kong), and the doctrine of absolute state immunity
(for foreign states). Immunity cannot be waived by the parties by way of including a waiver in
the underlying agreements. Immunity can, however, be waived in the context of a particular
dispute that has already arisen; or in advance, in an international treaty between the foreign
state and the forum state. Legal opinions may therefore include assumptions that the parties
are not Crown or foreign state entities.

Registry filings are made after the event and so are not up to date. The best evidence for
ascertaining directors and members of a company can be found in the statutory books kept
by the company, although these are not typically reviewed unless a shareholder is granting a
charge over its holding of shares in the company.

Where security is granted, the prohibitions set out in the underlying asset being charged
will impact upon whether the security can be realised. Obvious concerns are as follows:
\(a\) a charge over shares in a company where company directors have discretion not to
register a transfer of shares; and
\(b\) security over a contract where that contract does not permit parties to dispose of their
interests.

Legal opinions usually set out the relevant registry filings that must be made upon the creation
of security, and then assume those filings will be made within the prescribed time limits.

Legal opinions cover the valid creation of security, but do not go further to describe the
type and ranking of security given the complexities of this area of law.

\(^5\) R (on the application of Mercury Tax Group and another) v. Revenue and Customs Commissioners and others
VI LOAN TRADING

Loan trading is usually carried out by way of novation and assignment, and both methods are catered for in Asia Pacific Loan Market Association primary documentation. Sub-participations and synthetic methods are available but less commonly used.

VII OTHER ISSUES

If a lender is not an authorised institution licensed by the HKMA, it may fall under the Money Lenders Ordinance (Chapter 163 of the Laws of Hong Kong) if it is carrying on a business in Hong Kong (whether itself or through agents) of making loans, or if it advertises or announces itself as carrying on that business. This legislation seeks to protect consumers against unfair credit transactions, for example, by requiring money lenders to be licensed, and for money lenders to use prescribed forms and not to charge compound interest. Breach of the Money Lenders Ordinance may result in the commitment of offences, and underlying transactions being unenforceable. A number of loans are exempted from the above requirements (including the requirement to be licensed to lend money). A commonly used exemption is for loans made to a company that has a paid-up share capital of not less than HK$1 million (or its equivalent in another currency).

A lender who is not an authorised institution licensed by the HKMA must abide by the usury laws set out in the Money Lenders Ordinance, which requires loans and securities not to be ‘extortionate’. There is a statutory presumption that a transaction is extortionate where the effective rate of interest exceeds 48 per cent per annum.

VIII OUTLOOK AND CONCLUSIONS

There has been an expectation that Hong Kong’s insolvency regime will be updated to include debtor corporate rescue mechanics. At the time of writing, no indication as to timing has been given.

Hong Kong’s regulators are promoting green finance. In September 2018, mainland China, following its national strategy, became the second-largest green bond issuer in the world. A related upturn in green loan financings is expected.
I OVERVIEW

Although the Indian lending market was traditionally dominated by banks (both government-owned and private), a growing recognition by the Reserve Bank of India (RBI) and banks of increasing non-performing assets (NPAs) and stressed assets has put tremendous pressure on the banking sector. This resulted in a deceleration in growth of loans and advances (especially by public sector banks (PSBs)), although some rebalancing came about in 2017 and 2018 following a dip in issuance of commercial papers and corporate bonds (typically picked up by non-banking financial companies (NBFCs)).

Simultaneously, with efforts to discourage large borrowers from depending solely on the banking system for funding, the RBI and the government have attempted to open up new lending avenues for Indian corporates. New lending entities (such as foreign portfolio investors (FPIs) and alternative investment funds (AIFs)) have significantly increased their share in the market. The RBI is now focused on attracting long-term and stable funding from FPIs, through measures such as the ‘voluntary redemption route’, which exempts FPIs from regulatory lock-ins for individual investments if they commit to reinvesting their pool of funds in India for a specified period. Since the defaults by Infrastructure Leasing & Financial Services Limited (IL&FS) on various debt obligations in 2018, NBFCs have been facing liquidity issues, with the cost of borrowing increasing steeply for the sector, as well as rating downgrades and debt defaults. The RBI has now issued draft guidelines on liquidity risk management for NBFCs, to prevent any systemic crisis in the sector.

With Indian corporates looking for new (and cheaper) sources of funding, avenues such as ‘masala bonds’ (i.e., rupee-denominated bonds issued offshore by Indian corporates) have seen some success. The RBI has also made certain relaxations in the existing external funding measures.

1 L Viswanathan and Dhananjay Kumar are partners at Cyril Amarchand Mangaldas. The authors acknowledge the help received from Surya Sreenivasan and Gautam Sundaresh.
2 The RBI is the central bank constituted under the Reserve Bank of India Act 1934, which is accorded the statutory mandate to govern the functioning of the banking sector in India.
3 Gross NPAs in September 2018 were reported to be 10.8 per cent of gross advances of scheduled commercial banks in India, compared with 11.5 per cent in March 2018, https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/0FSRDECEMBER2018DAFEDD89C01C432786925639A4864F96.PDF.
4 RBI, Report on Trend and Progress of Banking in India 2015-16.
5 RBI, Report on Trend and Progress of Banking in India 2017-18.
commercial borrowing (ECB) framework, benefiting corporates looking to raise foreign currency loans to meet their capital needs. The Insolvency and Bankruptcy Code 2016 (the Insolvency Code) is proving to be a game-changer for corporate debt in India.

The Insolvency Code excludes corporates in the financial services sector from its scope. While the Financial Resolution and Deposit Insurance Bill 2017 (the Bill) was tabled before the Indian parliament for specified categories of financial service providers in distress, the Bill was withdrawn in the monsoon session of Parliament in 2018.

In October 2017, the government announced the recapitalisation of certain PSBs through the injection of capital by the government and directly from the markets. As at November 2018, 1,288,610 million rupees had been injected into various PSBs. The capitalisation was expected to provide an impetus to lending in India; however, the impact has not been immediately apparent.

Indian creditors do not usually adopt Loan Market Association (LMA) or Asia Pacific Loan Market Association (APLMA) standard documentation, and each creditor may use its own format of loan documents. Indian loan documentation is typically covenant-heavy on the borrower (especially in a special purpose vehicle or project financing).

II LEGAL AND REGULATORY DEVELOPMENTS

i Regulation of lenders

Banks in India are heavily regulated, with RBI guidelines governing interest rates, the extent of exposure to corporate groups, information sharing and reporting requirements, and other prudential aspects. Indian regulations permit NBFCs to engage in the lending business if they register with the RBI, although NBFCs are subject to lesser scrutiny. The RBI has introduced several measures aimed at reducing regulatory arbitrage between banks and NBFCs. The RBI and the Securities and Exchange Board of India have introduced lightly regulated lending vehicles such as AIFs and FPIs to widen the Indian investment market. Certain changes have been introduced to the FPI regime, which are detailed in Section VII.

ii Restructuring schemes

On 7 June 2019, the RBI introduced a new ‘Prudential Framework for Resolution of Stressed Assets’, to replace an earlier framework that was struck down by the Supreme Court. The circular mandates lenders to enter into an intercreditor agreement and agree on a plan for debt restructuring or resolution immediately on the occasion of a payment default, and gives benefits to lenders who refer borrowers under the Insolvency Code. Decisions are made by a specified majority of lenders, and bind all lenders.

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9 The Indian Banks Association has notified some standard formats, the broad terms of which are adopted by lenders.
10 RBI, Report on Trend and Progress of Banking in India 2015-16.
iii Insolvency Code

With the objective of effecting a complete overhaul of the earlier insolvency regime and instituting a creditor controlled process for the revival of defaulting companies (aligned with the approach in administration in the United Kingdom), the efficacy and the nuances of the Insolvency Code are currently being tested before various courts and tribunals, with over 1,484 companies currently undergoing a resolution process under the Code. The RBI has also been given the power to issue directions to banks to initiate insolvency resolution in respect of borrowers.11

Several important positions have already been taken by courts since the commencement of the Insolvency Code, including recent judgments clarifying that apportionment of payments to financial creditors and operational creditors under a resolution plan are to be done on an equal and proportionate basis.12

Several important amendments have also been made to the Insolvency Code to address the various issues that have cropped up during its implementation. One significant change was the inclusion of Section 29A,13 which introduced stringent eligibility criteria in respect of prospective resolution applicants to a distressed company (i.e., those seeking to submit resolution plans in respect of the insolvent entity), which prohibited promoters and companies with an unclean record or bad history in the credit market (on a worldwide basis), from bidding for the insolvent company.14 The disqualification criteria under Section 29A are also triggered where a disqualified entity or person is a 'connected person'15 of the resolution applicant. Other significant amendments include a provision that permits withdrawal from the insolvency process, with the approval of 90 per cent of the committee of creditors,16 and

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11 Although these powers were first exercised by the RBI in June 2017 to refer 12 companies to insolvency proceedings under an ordinance (i.e., an executive order), an amendment to the Banking Regulation Act 1949 was formally notified on 25 August 2017.


13 By way of the Insolvency and Bankruptcy Code (Amendment) Ordinance 2017, which was subsequently replaced by the Insolvency and Bankruptcy Code (Amendment) Act 2017.

14 The disqualification criteria set out under Section 29A include, inter alia: (1) being an undischarged insolvent or wilful defaulter; (2) having an account, or being the promoter of a company that has an account that has been declared to be a non-performing asset under the guidelines of the Reserve Bank of India, with a period of one year having elapsed from the date of such classification; (3) being convicted for an offence punishable with imprisonment of two years or more; (4) being prohibited by the Securities and Exchange Board of India from trading or accessing the securities market; and (5) having executed an enforceable guarantee in respect of a corporate debtor against whom proceedings have been initiated under the Insolvency Code.

15 A 'connected person' has been defined under the Explanation to Section 29A of the Insolvency Code as: (1) any person who is the promoter or in the management or control of the resolution applicant; (2) any person who shall be the promoter or in management or control of the business of the corporate debtor during the implementation of the resolution plan; or (3) the holding company, subsidiary company, associate company or related party of the persons mentioned in points (1) and (2). The definition of a 'related party' is very wide in respect of both individuals and companies.

16 Section 12A of the Insolvency Code. This was inserted by Act No. 26 of 2018, with effect from 6 June 2018.
India

doing away with the separate classification for ‘dissenting financial creditors’, who were earlier eligible to receive the liquidation value of their debt in priority to financial creditors that voted in favour of the resolution plan.\(^{17}\)

The treatment of convertible and structured instruments in an insolvency proceeding remains to be tested. Further, the provisions of the Insolvency Code that allow operational (trade) creditors to file proceedings against borrowers for smaller defaults have caused many creditors to strengthen cross-default clauses in loan documents, while also imposing stricter covenants on borrowers with respect to trade creditors.

iv Constitution of the NCLT

The NCLT and the National Company Law Appellate Tribunal (NCLAT) were constituted in June 2016. These are meant to be solely responsible for all company law disputes, assuming powers previously exercised by high courts, the Company Law Board and the Board of Industrial and Financial Reconstruction. The NCLT also functions as the adjudicating authority for all matters under the Insolvency Code (with the NCLAT functioning as the appellate authority).

v Basel III

Basel III implementation has commenced in a staged manner in India, with full implementation expected by 1 January 2022. Though it is generally expected that implementation of Basel III may increase lending rates, unlike LMA and APLMA jurisdictions, domestic creditors have not introduced a concept of ‘increased costs’ for Basel III implementation in loan documentation. Foreign creditors in India, however, adopt the LMA standard of reserving a right to claim increased costs from the borrower, subject usually to negotiated caps.

vi Sanctions and anti-corruption laws

In recent times, based on recommendations of the Financial Action Task Force and the Basel Committee, the RBI has issued various guidelines on compliance by banks with these standards\(^{18}\) in respect of monitoring accounts and reporting of suspicious activity.

Banks are also now subject to enhanced ‘know your customer’ (KYC) requirements, which are tailored to meet these guidelines. Most domestic banks require borrowers and security providers to complete a comprehensive KYC process as a condition precedent to disbursement. International banks, as well as domestic banks with a presence in the United States and the European Union, may additionally require borrowers to comply with requirements of the Office of Foreign Assets Control regime or the relevant EU regime. Typically, creditors do not look to extend compliance requirements beyond these regimes (except in transaction-specific cases).

Given the recent spate of financial frauds,\(^{19}\) the government introduced the Fugitive Economic Offenders Act 2018, which came into force on 21 April 2018. The legislation is intended to lay down measures to empower Indian authorities to attach and confiscate

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\(^{17}\) This was earlier provided for under Regulation 38(1)(c) of the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations 2016. This amendment came about by way of notification No. IBBI/2018-19/GN/REG032, dated 5 October 2018.

\(^{18}\) Consolidated in the RBI Master Direction – Know Your Customer (KYC) Direction, dated 25 February 2016, as amended from time to time.

\(^{19}\) Such as the US$2 billion fraud involving diamantaire Mr Nirav Modi and Punjab National Bank.
India

properties and proceeds of crime (in or outside India) associated with economic offenders who have left India or are refusing to return to India to avoid prosecution. The efficacy of these measures is currently being tested.

vii Marginal cost of funds-based lending rate

While RBI guidelines permit banks and NBFCs to determine interest rates linked to market-determined external benchmarks (such as the London Interbank Offered Rate), most domestic lenders adopt the ‘marginal cost of funds-based lending rate’ (MCLR). In April 2016, the RBI replaced the existing interest rate system with the MCLR. Under the MCLR, the lending rate is also pegged against changes in rates and costs of borrowing by banks, including the repo rate. The final lending rate offered to individual borrowers includes a ‘spread’ over and above the MCLR.

III TAX CONSIDERATIONS

i Withholding tax

An Indian borrower is required to withhold tax payable by a non-resident creditor on interest. Interest payable on a foreign currency-denominated loan is subject to a withholding tax of 20 per cent (plus applicable surcharge and cess), whereas interest on a rupee-denominated loan is subject to withholding tax of 40 per cent (plus applicable surcharge and cess). A lower withholding tax rate of 5 per cent (plus applicable surcharge and cess) may be available where an Indian company avails itself of a long-term foreign currency loan, or issues long-term foreign currency- or rupee-denominated bonds, subject to fulfilment of certain prescribed conditions linked to the Indian exchange control regulations. Interest on loans to Indian borrowers outside India for their offshore businesses is not subject to withholding tax in India, whereas loans taken out in India are subject to withholding tax.

Indian tax laws also offer lower withholding tax rates to certain foreign investors who qualify as FPIs. Generally, FPIs suffer a withholding tax of 20 per cent (plus applicable surcharge and cess) in the case of interest from any securities. However, a lower withholding tax rate of 5 per cent (plus applicable surcharge and cess) applies in the case of payment of interest on rupee-denominated bonds of an Indian company.

Non-resident creditors and FPIs may also be eligible to avail themselves of beneficial tax rates available under India’s vast array of double tax avoidance agreements (DTAAs). Certain DTAAs exempt interest income from tax, should the interest be paid to certain specified creditors (such as the government, specified governmental agencies, financial institutions, and statutory or local authorities). The rate of withholding tax on interest varies from 7.5 per cent to 40 per cent as per the DTAAs executed by India.

The introduction of the Goods and Services Tax in India may impact the cost of lending, since increased service tax will be leviable on banking services.

20 Surcharge may be zero per cent, 2 per cent or 5 per cent depending on the income thresholds. Rate of cess will be 4 per cent.
21 This reduced rate of withholding tax is applicable where the specified loans and bonds are issued before 30 June 2020.
22 Subject to fulfilment of certain conditions. Also, this reduced rate of withholding tax is applicable where the specified bonds are issued before 30 June 2020.
ii Documentary and transfer taxes

Documentary (or stamp) tax is payable on every document signed in India or signed outside India but brought into India (including, in some states, in electronic form). Therefore, if creditors anticipate a document being brought into India (i.e., for enforcement), stamp duty is usually paid at the time of signing. Rates of stamp duty on most documents are determined by the respective state governments for where the document is to be executed or for the location of the immovable property concerned. The rate of stamp duty payable on various types of security interests also varies significantly and is a consideration for creditors while choosing their security package. Following a 2015 judgment of the Supreme Court, although collateral is created in favour of a single agent or trustee in consortium lending, security documents are required to be stamped as though executed separately in favour of each creditor.

Loan trading transactions attract stamp duty. Though novation of commitment may attract a nominal stamp duty (since stamp duty is already paid on the loan agreement), stamp duty on an agreement for assignment of a loan and receivables (being treated as a conveyance of movables) attracts stamp duty ranging from 3 per cent to 14 per cent of the loan amount being assigned. To boost the securitisation market, however, the legislature has exempted securitisation transactions involving the transfer of rights or interest of banks or financial institutions in financial assets from stamp duty incidence.

Typically, the adequacy of stamp duty on instruments is tested when: (1) they are sought to be registered or otherwise presented to a public authority that has the authority to impound such documents under the stamp laws; or (2) they are sought to be enforced or relied on as evidence (in court proceedings or private dispute resolution proceedings such as arbitration).

Documentation is structured in a manner that minimises stamp duty incidence (such as by executing in states that have a lower stamp duty rate and agreeing to the jurisdiction clauses of such state).

iii FATCA and the CRS

In 2015, the Foreign Account Tax Compliance Act (FATCA) and the Common Reporting Standard (CRS) became applicable in India, under the intergovernmental agreements executed by the Indian government. These arrangements have been implemented by requiring financial institutions to share relevant data with the Central Board of Direct Taxes, which will then transmit this information to the relevant offshore authorities. The RBI has also modified its KYC and reporting guidelines applicable to lending institutions to incorporate the FATCA and CRS requirements. Creditors typically address FATCA compliance by requiring the borrower and other creditors to confirm their FATCA status, and each party bears its own FATCA deductions, with no gross-up (similar to the LMA arrangements on FATCA).

IV CREDIT SUPPORT AND SUBORDINATION

i Security

Types of security interests

Creditors can choose from a variety of security options to safeguard their exposure to borrowers and minimise risks associated with lending in India. Typically, high-value transactions involve

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23 Chief Controlling Revenue Authority v. Coastal Gujarat Power Limited & Ors, Civil Appeal No. 6054 of 2015 (arising out of SLP (C) No. 32319 of 2013).
the creation of multilayered security packages. Though creditors may have preference for the type of security that is to be created, industry and company-specific diligence plays a key role in charting out the strategy for assets to be secured as well as the type of security interest to be created, to ensure the highest degree of protection.

**Mortgages**

A mortgage is a transfer of interest in immovable property to secure an existing or future debt or the performance of an engagement that may give rise to a pecuniary liability. Although there are different types of mortgages that may be created in India (such as usufructuary mortgage, mortgage by conditional sale), in secured lending transactions involving immovable property as security, typically a mortgage in the English form or by deposit of title deeds is created. Many traditional lending institutions in India still require a borrower to mortgage some immovable property for any lending, since this is seen to provide a greater assurance than security over movable or financial assets. Working capital is typically secured by receivables and the stock-in-trade of the borrower.

A mortgage in the English form is the preferred form of security, since it involves a complete transfer of property to the creditor subject to the right of redemption of the mortgagee. It is typically associated with ease of enforcement, since a creditor has private remedies available (such as appointment of a receiver for the property) under law and does not have to rely on a court process for protection or enforcement of security. There is ambiguity regarding whether these remedies are available to foreign creditors, however. Legal structuring of a mortgage in the English form allows borrowers to charge or assign movables, contracts and other assets along with the immovable property, affording the benefit of private remedies and ease of mortgage enforcement to all such assets. A mortgage in the English form can, thus, effectively secure all assets of the borrower.

A mortgage by deposit of title deeds requires the deposit of title deeds of the property with the creditor with an intention to create security over the property (usually demonstrated by a declaration issued by the borrower at the time of deposit of the title deeds). The mortgage can be created only over immovable property and, therefore, does not afford the convenience of stapled security, unlike a mortgage in the English form.

**Pledges and liens**

A pledge is a special form of ‘bailment’ under law and, therefore, requires actual or constructive delivery of possession of the assets being pledged. Since transfer of possession restricts the ability of the borrower to use the secured assets, a pledge is usually created over shares and financial assets, which are not required for day-to-day operations. The pledge is created by handover of the share or security certificates to the creditor, or if the securities are in electronic form, by the marking of a pledge over the securities in the records of the depository,24 which ‘locks’ the securities and does not permit any transaction without the consent of the creditor. Pledges are usually accompanied by a power of attorney in favour of the creditor (or the trustee) for exercise of rights in respect of the securities on the occurrence of a default.

Pledges are taken as security in all kinds of financing, including project financing and mezzanine or structured financing, since they allow borrowers to leverage financial securities

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24 A depository is an entity registered with the Securities and Exchange Board of India to hold dematerialised securities in its system and maintain records for the beneficial owners of the securities.
held by them and provide ease of enforcement. Upon a default by the pledgor, a sale of the pledged assets can be effected without court intervention, and the proceeds can be used by the pledgee to discharge the pledgor or borrower of its obligations.

Indian law also recognises retention of title clauses and provides for security in the form of a lien to unpaid sellers.

**Charges and hypothecations**

Although movable assets are frequently ‘stapled’ with immovable property in an English mortgage (see the ‘Mortgages’ section), where immovable property is not available or is being secured by a mortgage by deposit of title deeds, creditors require the borrower to charge its movable assets (physical, financial and non-physical assets) under a hypothecation document. Though a stand-alone mortgage over movable properties has also been recognised, this is not the usual route adopted by creditors in India. A hypothecation is recognised in Indian law as a charge on existing or future movable property without delivery of possession. It is a contractual creation of a special property in assets, entitling the creditor to take possession of those assets in a default and sell them for realisation of outstanding debt. Both fixed and floating charges are recognised in India.

**Substitution rights**

In most public–private partnership projects (e.g., roads and airports), the government continues to own the project asset, with a concession being granted to the borrower to develop and operate the asset. Similarly, several assets such as telecom assets, spectrum and mining rights are owned by the government and licensed to private parties. These assets cannot be charged directly to creditors. Therefore, government authorities enter into tripartite arrangements with creditors, under which they allow the creditors a right to substitute the borrower with an eligible third party (subject to certain conditions). However, the sanctity of these arrangements is unclear.

**Common methods of taking security**

The most common types of security interests associated with certain types of assets are:

- real estate: by way of a mortgage over immovable property, which may also encompass all other assets of the borrower under a stapled security structure;
- tangible movable property: by way of a mortgage (if stapled with land) or a hypothecation;
- financial securities: usually by way of a pledge, delivering possession to the creditors;
- contractual rights, receivables, intellectual property, etc.: by way of a mortgage (if stapled with land) or a hypothecation. Additional perfection rights may be required depending on the nature of the asset (e.g., creation of charge over aircraft is required to be endorsed on the certificate of registration with the Directorate General of Civil Aviation). With respect to intellectual property, creation of any security interest is required to be notified to the relevant registration authorities.
Foreign creditors also require a no-objection certificate from the relevant authorised dealer\textsuperscript{25} prior to the creation of security over any Indian assets in their favour.

**Common methods of enforcement**

Enforcement of a security interest may be done either privately or through court intervention. A typical private enforcement process would take about two to four years, whereas a court process may extend to about 10 to 12 years. A mortgagee has the right to file a suit for foreclosure or sale on default in repayment; however, these rights have not been extended to foreign creditors under the Indian transfer of property regime. Thus, although foreclosure is not an option for mortgages in the English form or foreign creditors, creditors holding a mortgage in the English form are permitted to effect a private sale of the property or appoint a private receiver without approaching a court. The enforcement of a charge over movable assets requires the intervention of courts unless the terms of the underlying contract expressly provide for it. For a pledge, a creditor may simply sell the pledged assets in accordance with the terms of the underlying contract and after giving reasonable notice to the pledgor. Creditors have a duty to maximise recovery from secured assets.

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (the SARFAESI Act) provides creditors private remedies to enforce any security interest (except a pledge on movable assets or a lien). Where a substantial part of the business is held as collateral by the creditors (such as in a project financing), they are also permitted to take over the management of the borrower. In the case of consortium lending, approval of 60 per cent of the creditors in value is required for the exercise of powers under the SARFAESI Act, and the approval is binding on all creditors (including dissenting creditors). Remedies under the SARFAESI Act are also available to the listed bond market in India and to notified non-banking financial companies.

Debt recovery tribunals (DRTs) were established in India under the Recovery of Debts Due to Banks and Financial Institutions Act 1993. Creditors (including secured creditors who have not received full repayment from enforcement of security) may apply to the DRTs for recovery of debt. Recovery officers of the DRT are empowered to, inter alia, attach property of the borrower (even property that is not offered as collateral) and require third-party debtors of the borrower to repay debt amounts to the officer. The efficacy of approaching the DRTs to seek recovery of debt is severely hampered by an immense backlog of cases. It is estimated that there are over 100,000 cases pending before the various DRTs.\textsuperscript{26}

Under extant foreign exchange regulations, foreign creditors require authorised dealer approval for enforcement of security and repatriation of proceeds. Further, enforcement would also need to comply with generally applicable foreign exchange restrictions, including that the sale of immovable property can only be to a resident and any invocation of pledge is to be in accordance with the foreign investment policies.

\textsuperscript{25} Authorised dealer banks are banks that are authorised by the RBI to deal in foreign exchange in India.

\textsuperscript{26} www.livemint.com/Industry/kljsx5Uor7G4MB5WLVMN/Nearly-1-lakh-pending-cases-in-DRTs-data-shows.html (last accessed 10 June 2018).
Formalities and registration

Board approval

Any creation of security over a company's assets needs the approval of the board of directors of the company by way of a physical meeting. Creation of security over assets exceeding specified valuation thresholds or of third-party security for a loan to a group company also requires approval of three-quarters of the shareholders of a company. In the case of third-party security, additionally, the loan for which security is provided is required to be used for the principal business activities of the borrower.

Registration

All charges (including mortgages, pledges and liens) created over the property and assets of a company are to be registered with the Registrar of Companies within 300 days of the date of creation of the charge for the security interest to be enforceable as regards the company's creditors and its liquidator, for a fee ranging between US$3 and US$9.

Mortgages over immovable property (other than by way of deposit of title deeds) are also required to be registered with the sub-registrar of assurances in whose jurisdiction the property is situated. The registration fee varies across various states and may either be a capped amount (US$461 in Maharashtra) or ad valorem in respect of the amount secured. Mortgages by deposit of title deeds are required to be noted in the land registry in certain states.

Creditors are required to file details of mortgages created in their favour with the Central Registry of Securitisation Asset Reconstruction and Security Interest of India (CERSAI) under the SARFAESI Act. Additionally, specific assets may also require additional registration (i.e., the assignment or transmission of rights in relation to patents is required to be filed in the register of patents).

Particular challenges

Some of the specific challenges faced by creditors in the creation and enforcement of security are as follows:

a requirement of government consent for creation and enforcement of security. Consent of local authorities may be required in some states for mortgaging land, particularly if the creditor is not a recognised or notified creditor. Certain assets (such as production-sharing contracts or mining leases) require government approval for creation and enforcement of any security, and enforcement is also possible against a limited number of entities. Similarly, forest land cannot be mortgaged, as it belongs to the government and approval is required even for the removal of immovable plant and machinery located on it (which may itself be charged to the creditor). Securing government approvals may require approval of the relevant authority, and any transfer on enforcement may only be in favour of a similarly qualified entity;

b transaction costs remain high because of stamp and registration duties;

c private enforcement is limited to only certain types of creditors, and enforcement proceedings through the court process are highly protracted, resulting in a diminution in the value of the assets over time; and

d under Indian transfer of property laws, there may be dual ownership over fixed assets and the land on which such assets are located. This creates complications for the purposes of enforcement of security by creditors.
ii Guarantees and other forms of credit support

Corporate guarantees are usually sought by creditors from the parent or from associated companies of the borrower entity. Although guarantees are executed as deeds (and, therefore, do not require consideration to pass to the guarantor), most creditors require the guarantor to demonstrate consideration in the form of a corporate benefit accruing to it.

Given India's traditionally promoter-driven corporate market, creditors have historically required individual promoters to provide personal guarantees for corporate loans. Creditors also require promoters to provide personal guarantees as a condition of restructuring loans, on the principle that shareholders should bear the first loss. In view of the burgeoning NPA problem (see Section I), the RBI in 2014 allowed banks to classify guarantors who refuse to honour guarantees as 'wilful defaulters', restricting access to capital and debt markets. With the increasing focus on guarantors by both banks and regulators, many corporate groups resist guarantees by individual promoters. Creditors as beneficiaries of guarantees are also able to take the guarantor (following invocation) to a corporate insolvency resolution proceeding under the Insolvency Code.27

Group company guarantees require a host of corporate compliance criteria to be met, including approval of the shareholders of the guarantor and a condition that the loan should be used by the borrower company for its principal business activities only.

iii Priorities and subordination

Secured creditors continue to have better protection and preferential access to borrower assets than unsecured creditors.28 Certain encumbrances created under law also have priority over secured creditor rights (such as banker’s lien and an unpaid vendor’s lien). Since these rely on a preferential status because of possession, priority rules gain significance in the context of non-possessory securities (such as charges and mortgage).

In the absence of contractual provisions to the contrary, the following rules of priority are applicable under Indian law:

a. between two registered charges, the charge registered prior in time will have priority;
b. an equitable mortgage takes effect against any mortgage deed subsequently executed and registered in relation to the same property;
c. a mortgage of movables with possession has priority over a prior mortgage without possession;
d. a mortgagee of movable property without possession that comes to court first will have priority over subsequent such mortgagees that approach the court;
e. a fixed charge has priority over a floating charge;
f. between two floating charges, the one created earlier in time will have priority; and

The registration and fulfilment of perfection requirements of a charge give it priority over a non-registered and non-perfected charge, notwithstanding when the charge was created.


28 Under the Insolvency Code, secured creditors have the option of enforcing their security interests without relinquishing the same to the liquidation estate. In this scenario, the unpaid debt of secured creditors ranks at par with government dues and below unsecured financial creditors under the liquidation waterfall.
Contractual priorities in security are usually set out in an intercreditor or subordination agreement between the creditors. Intercreditor arrangements are fairly standard and are afforded sanctity by courts as well as participating lending institutions. It remains to be tested whether turnover subordination provisions will be binding on a liquidator appointed under the Insolvency Code or the Companies Act 2013.

Typical LMA and APLMA provisions requiring majority creditor consent for enforcement or other action against a borrower or obligor are viewed as unenforceable under Indian law, since the Indian Contract Act 1872 holds contracts restraining legal proceedings to be void. Therefore, enforcement priority in India is maintained by imposing wait periods (up to a year) on subordinated creditors for enforcement.

An intercreditor arrangement may become problematic where different types of creditors are party to it, since all creditors do not have equal access to special enforcement mechanisms. For instance, remedies under the SARFAESI Act are not available to foreign creditors who are not registered in India and to certain NBFCs. The imposition of wait periods for access to remedies under the SARFAESI Act also entitles some creditors to invoke remedies under the SARFAESI Act before others. Though an intercreditor arrangement may address these issues by requiring creditors who have the benefit of these regimes to share recoveries with other creditors, this results in an unsatisfactory situation where the notified creditors can not then recover their dues as they have (notionally) already received full payment from the borrower.

V LEGAL RESERVATIONS AND OPINIONS PRACTICE

i Limitations on the validity and enforceability of guarantees and securities

Although India broadly adopts a pro-creditor approach in ensuring the least possible hindrance in the enforcement of security interests and guarantees, there are certain limitations to enforceability that find their origin in law and apply in a universal fashion. These include the necessity of demonstrating a corporate benefit, aspects pertaining to financial assistance and the existence of clawback risks in the context of insolvency. These issues have been elaborated upon in more detail below.

ii Corporate benefit

A corporate benefit is required to be demonstrated in different ways, depending on the type of transaction being entered into, and the person or entity to whom loans are being advanced or on behalf of whom security interests are being created (e.g., in favour of lenders). There applies a blanket prohibition on loans being advanced or securities being created by a company in favour of its own directors or persons in whom the directors are interested. Exceptions to this rule include the provision of loans or securities as part of the service ordinarily extended by the company to its employees or pursuant to a scheme expressly approved by the members of the company.

Financial assistance

The Companies Act 2013 restricts public companies from giving loans or guarantees, or providing security or any financial assistance in connection with the purchase or subscription of shares by any person (including any shares in its holding company).
**Clawback risks**

As the insolvency regime applicable to corporate entities is spread over the provisions of the Companies Act 2013 and the Insolvency Code, there are several clawback risks that apply depending on the framework under which the relevant antecedent transaction is being scrutinised. These have been set out in the table below.

<table>
<thead>
<tr>
<th>Antecedent transaction</th>
<th>Counterparty to the transaction</th>
<th>Effect</th>
<th>Look-back period</th>
<th>Consequence</th>
<th>Who may apply</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fraudulent preference under the Companies Act 2013</td>
<td>Creditor, surety or guarantor</td>
<td>Puts person in better position in liquidation than would have been if no preference had been given</td>
<td>Six months prior to making of winding-up application</td>
<td>The NCLT may restore position to what it would have been if no preference had been given</td>
<td>Suo moto</td>
</tr>
<tr>
<td>Transfers not in good faith under the Companies Act 2013</td>
<td>A purchaser or encumbrancer in good faith and for valuable consideration</td>
<td>A transfer of property or delivery of goods not being a transfer or delivery made in the ordinary course of business</td>
<td>One year before presentation of a petition for winding up by the NCLT</td>
<td>The NCLT would deem the transfer or delivery void against the company liquidator</td>
<td>Suo moto</td>
</tr>
<tr>
<td>Creation of a floating charge under the Companies Act 2013</td>
<td>Any person</td>
<td>Creation of a floating charge on the undertaking or property of the company, unless it is proved that the company was solvent immediately after the creation of the floating charge</td>
<td>One year before presentation of a petition for winding up by the NCLT</td>
<td>The NCLT would deem the floating charge invalid except to the extent of any money paid in consideration for the charge together with interest on this amount</td>
<td>Suo moto</td>
</tr>
<tr>
<td>Extortionate credit transaction under the Insolvency Code</td>
<td>Any person other than financial service companies</td>
<td>Requires the company to pay exorbitant payments for credit provided or is unconscionable under laws of contracts</td>
<td>Two years from insolvency commencement date</td>
<td>Set aside the transaction, restore the position as it existed prior to the transaction, modify the transaction or pass any other order under Section 51(1) of the Code</td>
<td>Liquidator or resolution professional</td>
</tr>
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</tr>
<tr>
<td>Preferential transactions under the Insolvency Code</td>
<td>Creditor, surety or guarantor</td>
<td>Transfer of property or an interest thereof because of an antecedent financial liability, operational debt or other liability owed by corporate debtor having an effect of putting person in a better position than under waterfall mechanism under Section 53</td>
<td>Related party: during the two years preceding insolvency commencement date&lt;br&gt;Other than related party: during the one year preceding insolvency commencement date</td>
<td>Avoidance of preferential transactions or any other order made by the tribunal under Section 44 of the Code</td>
<td>Liquidator or resolution professional</td>
</tr>
<tr>
<td>Undervalued transactions under the Insolvency Code</td>
<td>Any person</td>
<td>A gift is made to a person; or a transaction is entered into that involves transfer of one or more assets or consideration that is significantly less than the value of consideration provided by corporate debtor</td>
<td>Related party: during the two years preceding insolvency commencement date&lt;br&gt;Other than related party: during the one year preceding insolvency commencement date&lt;br&gt;No look-back period is applicable in respect of transactions defrauding creditors</td>
<td>Undervalued transactions: declaration of transaction as void or reversal of effect of transaction (as provided under Section 48), and release of security created or return of benefits&lt;br&gt;Transactions defrauding creditors: restoration of the position as it existed before the transaction, as if the transaction had not been entered into; and any other order to protect the interests of the persons who are victims of the transaction</td>
<td>Liquidator, resolution professional, creditor, or member or partner of the corporate debtor</td>
</tr>
</tbody>
</table>

### iii Legal opinions practice

The issuance of legal opinions is standard practice for the purposes of Indian lending. Opinions usually contain statements regarding the capacity of the counterparty to execute the necessary documentation and to enter into the transaction. For the purposes of secured lending, these opinions also explicitly comment on the validity of the security interest being created. It is the creditors’ counsel who usually delivers the opinions. However, in some cases, opinions are sought from the borrower’s counsel along with a supporting confirmation from the creditors’ counsel.

### iv Choice of law

Decrees passed by courts of a ‘reciprocating territory’ may be executed in India as Indian decrees, except in certain limited circumstances (e.g., where the judgment has not been pronounced by a court of competent jurisdiction, where it has not been given on the merits of the case or where it appears on its face to be founded on an incorrect view of international law). The government notifies jurisdictions that qualify as reciprocating territories by way of notification in the Official Gazette. So far, only 12 jurisdictions have been notified as reciprocating territories, and this list does not include several key jurisdictions, including the United States. Judgments or decrees of courts in non-reciprocating territories can be enforced only by filing a lawsuit in an Indian court for a judgment based on the foreign judgment.
Pursuant to certain changes to the framework governing domestic and international arbitration, the scope for challenging a foreign award on the basis of violation of public policy has been narrowed, and awards have been prohibited from being set aside merely on the ground of an erroneous application of the law or by way of re-appreciation of evidence.

VI LOAN TRADING

Loan trading is common, with most documentation structures providing for loan trading without borrower consent by way of novation (usually of undisbursed commitment) and assignment (of a disbursed facility). Large loans involve agent and security trustee structures, allowing new creditors the benefit of existing collateral without requiring action on the part of the borrower. In the event of trading of bilateral loans, however, a release and recreation of security with the cooperation of the borrower is inevitable, which also has its own stamp tax and registration cost implications. See Section III.

Sub-participation and risk participation without a change to the creditor on record have seen an increase in Indian markets in light of the NPA issue, with the market having seen a lifetime high of transactions between April and December of 2018. This has encouraged banks to trade stressed assets. Securitisation (i.e., assignment of loans and receivables to asset reconstruction companies (ARCs) that issue security receipts to holders) is governed by the SARFAESI Act, which contemplates transfer of stressed assets to ARCs, which would then undertake recovery measures against the borrower. There has been a big push to promote these entities by the RBI and the Indian government recently, including by liberalising foreign investment in such companies. Foreign investment by eligible FPIs is also now permitted in securitised debt instruments issued by ARCs.

In September 2016, the RBI permitted banks to sell their stressed assets to other creditors, NBFCs and financial institutions. As per these guidelines, ‘scheduled commercial banks’ are required to identify assets for sale on an annual basis and periodically review the classification of their financial assets. Banks are also required to invite public bids for the same, to attract more buyers and improve the price discovery mechanism. Banks have also now been permitted to buy back financial assets that have been successfully restructured by ARCs (other than those that were sold by the banks themselves).

The Insolvency Code and its time-bound mechanism for acquisition of distressed assets has seen great interest from global distressed assets funds. Many funds with an India focus have raised a significant amount of capital recently to acquire debt positions from stressed banks looking to offload non-performing and stressed assets.

Since a resolution process under the Insolvency Code requires 66 per cent positive votes from creditors, loan trading has assumed greater significance for companies that are in

30 Press Note No. 4 of 2016 issued on 6 May 2016 by the Department of Industry Policy and Promotion, Ministry of Commerce and Industry, government of India.
the middle of a corporate insolvency resolution process. The Indian Banks Association has therefore requested its member banks not to sell stressed assets of companies undergoing insolvency resolution proceedings without informing other lenders in the consortium.\

VII  OTHER ISSUES

The ‘concentration limits’ applicable to FPIs, stipulated that related FPIs’ exposure to a corporate group could not exceed 20 per cent of their portfolio; however, this was repealed by a circular issued by the RBI. The limit with respect to 50 per cent of a single issuance continues to be applicable as it has not been expressly altered. The earlier ‘lock-in’, which permitted FPIs to invest in unlisted corporate debt securities only subject to a minimum residual maturity of three years, has been reduced to one year, although the end-use restrictions continue to be applicable.

The changes to the external commercial borrowing regime (discussed in Section I), while aiming to liberalise the regime, have also restricted the access of investment companies and infrastructure investment trusts (among others) to cheap offshore debt.

Besides this, there also apply several restrictions on remittances outside India. Any remittance of proceeds from the enforcement of security by a secured creditor may also require RBI approval.

Another development that creditors may need to be mindful of is the notification of the Real Estate (Regulation and Development) Act 2016, which provides for greater regulation of borrowers in the real estate sector and, inter alia, stringent timelines for the completion of projects, and restrictions on the usage of money received from buyers for purposes other than for the development of the project. The empowered authority under the Act is authorised to revoke the registration of promoters for contravention of provisions of the Act. Lenders to borrowers in the real estate sector may be required to enforce stricter compliance and escrow mechanisms.

VIII  OUTLOOK AND CONCLUSIONS

The Indian lending market is currently in a state of transition, and the RBI’s proposed new measures for debt restructuring will play an important role in shaping India’s debt market for the next two to three years.

The Insolvency Code continues to find favour with lenders looking to recover non-performing debt, and the government’s continued support could mean an upswing in insolvency cases. Regulators continue to try and attract offshore debt funding through liberalisation in the ECB and FPI regulations, with a focus on attracting stable and long-term investors. It remains to be seen whether these measures will overhaul the corporate debt market in India.

I OVERVIEW

General

Infrastructure development has been the top priority for the government under President Joko ‘Jokowi’ Widodo. The Jokowi administration is continuing with many initiatives intended to increase infrastructure spending to 2019. The government has been active in supporting players to obtain funding through alternative financing. In this regard, the government through its National Development Plan Agency has developed its task forces to boost the implementation of non-government budget funding for infrastructure projects. The alternative financing sources can be obtained from capital markets, managed funds, banking, insurance and other financing structures. A lot of recent cross-border financing is also related to the financing for infrastructure projects. Non-governmental infrastructure financing projects are targeted to reach a total value of US$30 billion in 2018. According to the Financial Services Authority (OJK), infrastructure project loans have been constantly increasing from 19.5 trillion rupiahs in 2015 to 44.4 trillion rupiahs in 2018.

In its external debt, Indonesia saw a slow increase in the first quarter of 2019 according to Bank Indonesia (BI). Total external debt was recorded at US$388.7 billion, only US$4.8 billion higher compared with the value at the end of the previous quarter. In the private sector, the loan demand for working capital and investment decreased to 68.2 per cent from 77 per cent in the previous quarter, and 74.7 per cent from 83.1 per cent in the previous quarter respectively. In contrast, statistics indicate an increase in loan demand for consumption, primarily for vehicle ownership. Private external debt is dominated by the financial and insurance services, manufacturing, power and mining sectors. Together, they constitute 74.2 per cent of total private external debt. Government debt was growing at 7.3 per cent (year-on-year) following the issuance of sharia government bonds in the framework of green bonds, and improvement in the global money market. Government external debt constituted 49 per cent of total external debt in the first quarter of 2019.

1 Sri H Rahayu is a partner, and Indra Prawira and Indriana Pramesti are associates at Rahayu & Partners in association with HFW.
4 ibid.
5 ibid.
6 ibid.
Recent deal activity

Towards the end of 2018, Indonesia secured an (approximately) US$9.4 million loan from Japan for the second phase of the mass rapid transit project in Jakarta. The loan, which was made available through the Japan International Cooperation Agency, has a tenor of 40 years with an annual interest rate of 0.1 per cent. Previously in 2015, Japan agreed to provide (approximately) US$17 million to finance the first phase of the project.7

In the power sector, state electricity company PT PLN (Persero) bagged a US$1.18 billion loan with a 10-year tenor to finance the construction of a 35,000MW electricity programme. The syndicated loan involved seven local financial institutions, including PT Bank Rakyat Indonesia (Persero) Tbk, PT Bank Mandiri (Persero) Tbk, PT Bank Central Asia Tbk, PT Bank CIMB Niaga Tbk, PT Sarana Multi Infrastruktur (Persero) and two sharia-based lenders, PT Bank BNI Syariah and PT Bank BCA Syariah. The loan was divided into two schemes, with 80 per cent funded by a conventional loan and the remaining under a sharia scheme.

Another transaction in the energy sector was concluded by PT Medco Power Indonesia (Medco), through its subsidiary PT Medco Ratch Power. Medco signed a US$222 million loan agreement with an international financing lenders consortium consisting of Asian Development Bank (ADB), International Finance Corporation (IFC), MUFG Bank, Ltd (MUFG) and Sumitomo Mitsui Banking Corporation. The 20-year tenor loan constitutes 76 per cent of the total investment to develop a 275MW combined cycle power plant in Riau.8

In sharia principle securities transactions, the government issued global Reg S/144A sukuk certificates of US$1 billion for five years and US$2 billion for 10 years due in 2022 and 2027, structured based on the sharia principle of agency contracts or Wakala. These global financial certificates are the largest US-dollar sukuk issued by the government of Indonesia to date and the largest non-Gulf Cooperation Council US-dollar sukuk transactions that have ever been issued.

II LEGAL AND REGULATORY DEVELOPMENTS

i Prudential principles in bank external debt and other liabilities in foreign currency

BI issued Regulation 21/1/PBI/2019 (Regulation 21) on 7 January 2019 (in effect since 1 March 2019), which broadens the scope of prudential principles to bank external debt and foreign currency-denominated liabilities, including domestic foreign exchange bonds and risk participation transactions. When applying prudential principles, Regulation 21 divides these liabilities into short-term and long-term liabilities.

Banks are required to limit the daily balance position of short-term and long-term liabilities in which the maturity is shortened to one year to a maximum of 30 per cent of the bank's capital. Several short-term liabilities are exempt from this restriction, including the following:

a those that are highly necessary to overcome urgent problems or to comply with laws and regulations;

b short-term liabilities from shareholders to ease liquidity problems;

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banks’ obligations to non-citizens resulting from hedging transactions;
d giro held by non-resident non-controlling shareholders for the distribution of credit to infrastructure projects; and
e giro held by non-residents that accommodate funds from the issuance of bonds denominated in rupiah by supranational institutions for the financing of infrastructure projects.

Banks are required to obtain the approval of BI prior to entering the long-term liabilities market by submitting an application for approval and incorporating the plan to enter the market in the bank’s business plan. The requirement to include long-term liabilities in a bank’s business plan is not applicable to a subordinated loan carried out on the recommendation of the OJK or long-term liabilities that are necessary for overcoming urgent problems and compliance with laws and regulations.

ii First fintech lending regulation in Indonesia
The OJK issued the first regulation on financial technology (fintech) lending activities in Indonesia – OJK Regulation No. 77/POJK.01/2016, dated 28 December 2016, concerning Information Technology-Based Lending Services. This regulation is expected to support the growth of the fintech lending industry and peer-to-peer (P2P) lending platforms in Indonesia as a new financing alternative to conventional financial services industries.

It is also expected that P2P lending providers will open access to overseas or domestic loans from various areas to the Indonesian general public as part of the government efforts to support the National Strategy of Financial Inclusion.9

iii The implementation of Basel III
The government, namely BI and the OJK, has issued several regulations in regard to the implementation of Basel III. Related key regulations include OJK Regulation No. 11/POJK.03/2016, dated 29 January 2016, regarding the Minimum Capital Adequacy of a Commercial Bank.

This regulation requires commercial banks to comply with minimum capital adequacy in accordance with their risk profiles and to establish additional capital as a buffer.

Capital requirements
Minimum capital shall be calculated using the ratio of minimum capital adequacy and be set forth at no less than:

- 8 per cent of risk-weighted assets (RWA) for banks with a risk profile rating 1;
- between 9 per cent and 10 per cent of RWA for banks with a risk profile rating 2;
- between 10 per cent and 11 per cent of RWA for banks with a risk profile rating 3; or
- between 11 per cent and 14 per cent of RWA for banks with a risk profile rating 4 or 5.

Capital for banks having their head office in Indonesia shall consist of:

- Tier 1, no less than 6 per cent of RWA, with Common Equity Tier 1 no less than 4.5 per cent of RWA; or
- Tier 2, no greater than 100 per cent of Tier 1.

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Tier 1 capital of a bank must primarily consist of high-quality capital instruments, namely common stocks and profit balance that form part of Common Equity Tier 1. A component of Tier 1, namely Additional Tier 1, shall only include financial instruments that are subordinated with non-cumulative payments of dividends or yields that meet a number of particular criteria. In line with the improvement in quality of Tier 1, a component of Tier 2 instruments has also been adjusted to include: (1) a capital instrument in the form of shares or in another form that meets the requirements referred to in the regulation; (2) agio or disagio deriving from the issuance of a capital instrument that is classified as Tier 2; (3) the general provision for loan losses no greater than 1.25 per cent of RWA; and (4) the purpose reserve.

A bank branch office domiciled overseas must fulfil the minimum capital equivalency of maintained assets set at 8 per cent of the total obligation of the branch office every month at a minimum of 1 trillion rupiah.

**Additional capital requirements**

Other than minimum capital adequacy, banks must establish additional capital as a buffer in the form of:

- a capital conservation buffer at 2.5 per cent of RWA, which shall be applicable to a bank that is classified as a business activities-based commercial bank (BUKU) 3 or BUKU 4;
- a countercyclical buffer in the range of zero up to 2.5 per cent of RWA, which shall be applicable for all banks; and
- a capital surcharge for domestic systemically important banks in the range of 1 per cent up to 2.5 per cent of RWA, which shall be applicable for a bank that is deemed to have the potential to be systemic.

The obligation to establish a capital conservation buffer is being applied gradually from 2016 to provide sufficient time for the banks to establish the additional capital, and is now fully effective commencing January 2019.

**OJK Regulation 42/2015**

Under this regulation, banks shall maintain sufficient appropriate liquidity and report bank liquidity analysis to the OJK, calculated using a liquidity coverage ratio (LCR) of no lower than 100 per cent on an ongoing basis. The LCR is a comparison between high-quality liquidity assets (HQLA) and total net cash outflows over the 30 days following a stress scenario. This requirement shall only apply to banks included in the BUKU 3 and 4 groups, the branch office of a bank domiciled overseas and foreign banks other than the branch office of the bank domiciled overseas. This fulfilment of LCR by banks has been implemented gradually since 2015 and reached 100 per cent on 31 December 2018.

Aside from the obligation to maintain the LCR, banks shall also monitor the condition and liquidity adequacy by using certain indicators (monitoring tools), which include the following:

- contractual maturity mismatch, which indicates banks' potential liquidity needs for defined periods when outflows occur;
- funding concentration, which aims to identify those sources of corporate funding that are of such significance that withdrawal of this funding could cause liquidity issues;

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10 OJK Regulation No. 42/POJK.03/2015, dated 23 December 2015, regarding the Obligation on the Fulfilment of the Liquidity Coverage Ratio for Commercial Banks.
available unencumbered assets, which have the potential to be used as collateral so that it can be taken into account as HQLA or funding can be obtained from the secondary market or central bank;

d
the LCR based on significant currencies, to capture potential mismatches in certain currencies. This indicator uses the Basel LCR definition and calculation. A currency is considered significant if the aggregate liabilities denominated in that currency amount to 5 per cent or more of the bank’s total liabilities; and

e market-related monitoring tools, including market information, information on the financial sector and bank-specific information.

The Basel Committee on Banking Supervision’s ‘Assessment of Basel III LCR regulations’ in Indonesia in 2016 reported that the implementation of the key components of the LCR, such as HQLA (numerator), net outflows (denominator), net inflows (denominator) and LCR disclosure as contained in OJK Regulation 42/2015, is in compliance with Basel III.

OJK Regulation 50/2017

Complementing the regulation regarding the LCR requirement, OJK Regulation 50/2017 stipulates that banks belonging to the BUKU 3 or 4 groups and foreign banks must maintain adequate stable funding, which shall be calculated using a net stable funding ratio (NSFR) of no lower than 100 per cent. The NSFR shall be the ratio between total stable liabilities and equity for a period of one year to finance the activities of the bank (the available stable funding) and the total assets and off-balance sheet transactions that need to be funded by stable funding (the required stable funding). The obligation to fulfil a monthly NSFR was performed for the first time for the final report position of January 2018.

iv Development of anti-corruption laws and regulations

Indonesia’s reformation of anti-corruption laws and institutions started with the ratification of the United Nations Convention against Corruption on 18 April 2006, through Law No. 7 of 2006 regarding Ratification of United Nations Convention Against Corruption. Following the ratification, the government established several supporting agencies, including the internationally acclaimed Corruption Eradication Commission, the Court for Corruption Crimes, the Financial Transaction Reports and Analysis Centre and the Witness and Victim Protection Agency.

Prior to that, the century-old Indonesian Penal Code provided several principal provisions relating to criminal offences conducted by officials. Aiming to fill the gap left by the Penal Code, the government issued Law No. 31 of 1999, dated 16 August 1999, on the Eradication of the Criminal Act of Corruption as amended by Law No. 20 of 2001, dated 21 November 2001, which broadens the scope of parties punishable for corrupt practices to include not only state officials but also individuals and corporations, adds the types of activities categorised as corruption offences and increases the sanction for breach of provisions.

Other penal sanctions are stipulated under Law No. 8 of 2010, dated 23 October 2010, regarding the Prevention and Eradication of Criminal Act of Money Laundering (Law 8/2010), which applies to an extensive list of proceeds from criminal acts, including those from the

11 OJK Regulation No. 50/POJK.03/2017, dated 12 July 2017, regarding Mandatory Fulfilment of Net Stable Funding Ratio for Commercial Banks.
banking and capital market sectors as well as banknote counterfeiting. Penalties for money laundering under Law 8/2010 include imprisonment for five to 20 years, as well as a fine of 500 million to 100 billion rupiah.

In terms of prevention of corruption, the government has included an open data policy under Law No. 14 of 2008, dated 30 April 2008, on the Disclosure of Public Information, which enforce citizens’ right to access public information. Following that, the recently enacted Presidential Regulation No. 13 of 2018, dated 5 March 2018, on the Application of the Know-Your-Beneficial-Owner-Principle by Corporations for the Prevention and Eradication of the Criminal Acts of Money Laundering and Terrorism Financing, requires corporations to disclose the name of an individual beneficial owner. This is an addition to the existing disclosure regime in the financial sector issued by the OJK through Regulation No. 12/POJK.01/2017, dated 21 March 2017, regarding the Implementation of Anti-Money Laundering and Prevention of Terrorism Financing (APU-PPT) Programmes in the Financial Sector; and by BI through Regulation No. 19/10/PBI/2017, dated 11 September 2017, regarding the Implementation of APU-PPT for Non-Bank Payment System Service Providers and Non-Bank Money Changing Service Providers.

**v Regulation on green financing**

Reinforcing its commitment to provide solutions for environmental issues through environmentally friendly financing products, the OJK released Regulation No. 60/POJK.04/2017 regarding the Issuance of and Requirement for the Issuance of Environment-Oriented Debt Securities (Green Bonds) on 21 December 2017. This regulation provides opportunities to gain additional funding through the issuance of a green bond for environment-oriented projects in 11 sectors, including those in renewable energy, water and wastewater management, environmentally friendly transportation and pollution control. Under this regulation, the issuer must use at least 70 per cent of the green bond proceeds to finance environment-oriented business activities.

**vi Regulation on infrastructure financing**

In July 2017, the OJK issued Regulation No. 52/POJK.04/2017 on Infrastructure Investment Funds in the Form of Collective Investment Contracts. This regulation provides a legal framework for the issuance of alternative infrastructure collective investment contracts (DINFRA), which are intended as a funding alternative for the development of infrastructure in Indonesia through securitisation of assets. It is an innovation to provide flexibility to investment managers in managing investment portfolios as DINFRA can be offered through public offering or an alternative. Important points under the regulation include guidelines for issuance of DINFRA participation units, guidelines for management of DINFRA, collective investment contracts, transparency documents, recording and reporting obligations and dissolution of DINFRA.
III TAX CONSIDERATIONS

i Withholding tax

Withholding tax is applicable to domestic or foreign lenders for the interest payable on the principal loan. Under the Income Tax Law, any income received by domestic or foreign taxpayers will be subject to withholding tax, including interest incurred from loans, which includes premiums, discounts and compensation for loan repayment guarantees.\(^\text{12}\)

A foreign individual or a foreign entity not domiciled in Indonesia but who receives or accrues income from Indonesia will be considered as a foreign or non-resident taxpayer under the Income Tax Law. Interest payments made to a foreign lender – either a foreign individual or entity – will be subject to a 20 per cent withholding tax.

If a foreign lender resides in a jurisdiction that has a tax treaty with Indonesia, the withholding tax rate may be reduced or eliminated under the provisions of the tax treaty. Indonesia has tax treaties with 65 countries, including Australia, Austria, Belgium, Canada, China, Denmark, Egypt, Finland, France, Germany, Hong Kong, India, Italy, Japan, North Korea, South Korea, Luxembourg, the Netherlands, New Zealand, Norway, Singapore, Spain, Sweden, Switzerland, Taiwan, the United Arab Emirates, the United Kingdom and the United States.

ii Registration and notary fees, and stamp duty

Registration and notary fees for security over land (mortgages) and fiduciary securities are normally applied based on the value of the secured amount.

Particular to fiduciary transfers, a government regulation imposes a limitation on notary fees for preparing a deed of fiduciary transfers.\(^\text{13}\) Notary fees are capped as follows:

- \(a\) a maximum 2.5 per cent of security values up to 100 million rupiah;
- \(b\) a maximum 1.5 per cent of security values between 100 million and 1 billion rupiah; and
- \(c\) for a security values above 1 billion rupiah, the fee can be determined as agreed between the notary and the relevant party with a maximum 1 per cent of the security values.

For documentary taxes, any agreement signed by the parties with a transaction value above 1 million rupiah is subject to a stamp duty of 6,000 rupiah.

iii FATCA

On 18 March 2010, the government of the United States issued the Foreign Account Tax Compliance Act (FATCA) to overcome tax avoidance and tax evasion by US citizens who conduct direct investment through overseas financial institutions or indirect investment through overseas ownership of companies.

In relation to the application of FATCA in Indonesia, the government of Indonesia and the United States reached an ‘agreement in substance’ through an intergovernmental

\(^{12}\) Law No. 7 of 1983 concerning income tax as last amended by Law No. 36 of 2008 on the Fourth Amendment of Law No. 7 of 1983.

agreement (IGA), which came into effect on 30 June 2014. To comply with the provisions of FATCA, the government of Indonesia has decided to pursue a reporting model on the basis of an agreement agreed between the government of Indonesia and the government of the United States. Under the agreement, the government of Indonesia has committed to provide data and information on US taxpayers to the US government. The implication of this agreement is that the Indonesian financial institutions and companies that are categorised as foreign financial institutions, and certain non-financial foreign entities are required to identify accounts belonging to US citizens, to provide information about these accounts and information on US nationals who have accounts of foreign companies (in general, more than 10 per cent). In relation to the lending transactions and activities in Indonesia, this information includes the income received by US citizens or related companies in the form of interest, including premiums, discounts and fees, from providing guarantees in relation to loan transactions.

To support the tax avoidance and tax evasion prevention programmes, the government issued the Minister of Finance Regulation No. 125/PMK.010/2015, dated 7 July 2015, which has recently been amended and replaced by the Minister of Finance Regulation No. 39/PMK.03/2017 on the Procedure of Exchange of Information based on International Agreement. The OJK has also issued Regulation No. 25/POJK.03/2015 on the Information Disclosure of Foreign Customers related to Taxes to State or Jurisdiction Partners. These regulations have become the legal basis for Indonesian financial institutions for reporting on their customers’ data and information to the tax authority of the state or jurisdiction partner.

In the data and information reporting process that relates to FATCA, the OJK provides a reporting system for US customers that can be used by Indonesian financial institutions to submit a report to the OJK and then forward it to the Directorate General of Taxes (DGT) as the tax authority in Indonesia. Further, the report will be submitted by the DGT to the Internal Revenue Service.

In relation to the provisions on the Indonesian Banking Law, which regulates bank secrecy and customer accounts confidentiality, the government is now in discussions to revise these provisions to be in line with the implementation of FATCA in Indonesian banking and financial institutions activities.

**iv  Convention on Mutual Administrative Assistance in Tax Matters**

Indonesia signed the Convention on Mutual Administrative Assistance in Tax Matters on 3 November 2011, which was ratified on 17 October 2014 through presidential Regulation No. 159 of 2014 on the Ratification of Convention on Mutual Administrative Assistance in Tax Matters. Further to implementing this policy, the OJK has prepared a number of regulations in relation to the application of automatic exchange of tax information, which were implemented in September 2018.

In furtherance of this ratification, the government of Indonesia has also signed a Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information. The government is committed to implementing this agreement by using the

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15 OJK Quarterly Report 2016 (Quarter I).
Common Reporting Standard issued by the Organisation for Economic Co-operation and Development. Indonesia conducted the first reporting in 2018 and, in preparation for the exchange of information, the government issued a regulation as a basis to implement this policy as regulated under government regulation in lieu of Law No. 1 of 2017 on the Financial Information Access for the Interest of Taxes and several implementing regulations, among others – the Minister of Finance Regulations No. 39/PMK.03/2017 on the Procedures on Exchange of Information based on International Agreements.

IV  CREDIT SUPPORT AND SUBORDINATION

i  Security

The most common forms of securities under Indonesian law are described below.

Real estate (land)

Security rights over land may also be understood as mortgage in other jurisdictions. A security right over land is commonly taken to secure land with land titles and all fixtures attached to it for the purpose of securing the repayment of loans.

Security rights over land are governed by Law No. 4 of 1996 on Security Rights Over Land Including Objects Related to the Land (Law 4). Under Law 4, security rights over land will not entitle the security rights holder to ownership of the land title upon the borrower’s default. It does, however, grant the security rights holder the right with executorial force to sell the land when the borrower is in default, either privately or through public auction, to satisfy loan repayments from proceeds of the sale. The security rights holder will be entitled to the preferential right for the debt settlement over the other creditors.

A deed of grant of security rights over land must be drawn up by and signed before the land deed officer of the jurisdiction where the secured land is located. The deed must be drawn up in the official Indonesian language, Bahasa Indonesia, and in the form provided by the land deed officer. Subsequently, the deed of grant of security rights over land must be registered at the relevant land registration office of the National Land Agency. The security rights over land are effective on the date of registration in the land register maintained by the relevant land registration office. Upon registration of the security rights, the land registration office will issue a certificate of security rights over land to the security holder.

Fiduciary security

Fiduciary security is the common form of security over movable assets, either tangible or intangible, and certain immovable assets such as buildings that cannot be the subject of security rights over land under Law 4. Movable assets that can be taken as fiduciary security include machinery, raw materials, inventory and vehicles. Receivables can also be taken as fiduciary security.

Fiduciary security is governed under Law No. 42 of 1999 on Fiduciary Transfer (Law 42). As with security rights over land, fiduciary security grants the fiduciary security holder the right with executorial force to sell the secured assets, either privately or through public auction, when the borrower is in default. The fiduciary security holder is also entitled to the preferential right to debt settlement over other creditors.

A deed of fiduciary transfer agreement must be drawn up by and signed before a notary. This fiduciary deed must be in Bahasa Indonesia and is to be the accessory contract to the underlying loan agreement between the lender and the borrower. Under this deed, the
borrower (transferor) transfers the legal title over the secured assets to the lender (transferee) for so long as the debt remains outstanding. The fiduciary deed must be registered at the relevant fiduciary registration office. The fiduciary deed is perfected on the date of registration in the fiduciary register maintained by the fiduciary registration office. Upon registration, the fiduciary registration office will issue a certificate of fiduciary security to the security holder.

**Pledge**

A pledge is a form of security that can only be taken over movable assets, either tangible assets (such as machinery, equipment and vehicles) or intangible assets (such as shares, account receivables, bonds, debentures and patent rights), to secure a specified loan.

Pledge security is governed under Articles 1150 to 1160 of the Indonesian Civil Code (ICC). Under the ICC, a pledge must be made by agreement between the debtor or the borrower (pledgor) and the creditor or the lender (pledgee). Indonesian law does not require the pledge agreement to be made as a notarial deed or as a private agreement. However, in practice, pledge agreements are normally made in the form of notarial deeds for the purpose of evidencing in court and execution. In addition, pledge agreements may be attached with a power of attorney to sell the pledged assets, providing the pledgee to sell the pledged assets privately without using a public auction mechanism.

Pledges entitle the pledgee to the preferential right over other creditors to satisfy loan repayments from proceeds of the sale of the pledged assets. The perfection of pledge security may be different depending on the form of the pledged assets. The establishment of a pledge can be described as follows:

- A pledge over tangible movable assets will be effective on the deliverance of the goods to the pledgee. The pledged assets must be in the possession of the pledgee.
- A pledge over intangible movable assets will be perfected upon the notification of the pledge to the concerned party, by which the right of pledge will be enforced against the concerned party.
- A pledge over shares will be effective upon the notification and recording of the pledge in the share register of the relevant company. If the shares are in certificated form, the original certificate of shares must be delivered to the pledgee. For shares listed on the Indonesia Stock Exchange, the pledge can be established upon the notification of the pledged shares to the company and the recording of the shares by the Stock Administration Bureau appointed by the company in the company's share register. If the shares are listed in scriptless form, the pledgor must also notify the Indonesian Central Securities Depository, and it will certify the pledged shares.

**Hypothec**

With the enactment of Law 42, land can only be taken as security under security rights over land and not under a hypothec. A hypothec is a form of security that can be taken over immovable assets that cannot be secured by security rights over land. A hypothec can be taken to secure the borrower's assets in the form of vessels and aircraft. Further, the ICC stipulates that only vessels with a gross weight of 20 cubic metres or more can be encumbered by a hypothec. Vessels below this weight may be taken as security under fiduciary security or a pledge.

In general, hypothecs are regulated under ICC Articles 1162 to 1232. Under the ICC, a hypothec must be made by a deed of hypothec agreement between the creditor and the borrower, and the deed must be registered in the public registry. More specific procedure
is applicable for the encumbrance of a hypothec over a vessel. Minister of Transportation Regulation No. 39 of 2017 on Registration and Nationality of Ships requires the placement of a hypothec to be documented in a deed of hypothec made before the Official for the Registration and Recording of Ship Transfers of Title (the Ship Registration Official) at the place where the ship is registered. The hypothec shall be in effect once it has been registered and recorded in the Main Register of Ship Registration by the Ship Registration Official.

Although Indonesian shipping law provides that a hypothec deed shall have executorial power – meaning it can be enforced as though a final court decision – it falls short of setting a clear procedure for enforcement. Thus, in practice, a hypothec is enforced by filing a motion to foreclose to the district court. Upon receipt of the court order, a public action will be conducted by the State Auction Office.

Indonesia’s shipping industry is of the view that the lack of a comprehensive law on shipping hypothecs, including their enforcement, raises challenges to realising Indonesia’s aim to be a leading country in the maritime industry. Government action is, therefore, sought and urgently needed to improve the regulatory framework, particularly in financing Indonesia’s shipping industry.

ii Guarantees and other forms of credit support

Guarantees

Guarantees are commonly used under the Indonesian jurisdiction. Based on ICC Article 1820, a third party (either a personal or corporate guarantor) may guarantee the fulfilment of the borrower’s debt to the lender by the consent of such guarantor. A guarantee can be established by a written agreement made by the guarantor and the beneficiary, in the form of either a notarial deed or a private agreement. Indonesian law does not require that the guarantee agreement must be registered for it to be perfected.

The legal capacity to act as a guarantor is subject to the guarantor’s incorporation documents (if the guarantor is in the form of a corporation or a limited liability company). The guarantor must be permitted by its incorporation documents to act as a guarantor for the other party’s (borrower’s) debts. The guarantor must also obtain relevant internal approval, if any, as governed under its incorporation documents.

The lenders, therefore, are recommended to check whether the requirements mentioned above are satisfied under the relevant incorporation documents. If the requirements are not met, the guarantor would be considered as having no legal capacity to act as a guarantor, and, therefore, the guarantee cannot be enforced against the guarantor. In this case, the director of the company who acted and conducted the execution of the guarantee agreement on behalf of the company without complying with its incorporation documents would be held personally liable for the guarantee.

Other forms of credit support

Forms of credit support such as quasi-security structures are uncommon in Indonesia. With respect to enhancing a creditor’s protection against a debtor, the parties may enter into any agreements that can bring benefits to supporting the loan transactions, such as indemnity, performance bonds, bank guarantees, standby letters of credit or negative pledge undertakings as a clause in an agreement. Based on ICC Article 1338, stipulating the principle of freedom of contract, parties having legal capacity may enter into an agreement, and the agreement will apply to the parties as statute (provided that the contract has no illegal purpose or duress). However, the execution of certain agreements as a form of credit support
will not be recognised as security rights under Indonesian law, and will only bind the parties as contractual obligations and will not grant preferential rights to debt settlement over other creditors as a security right.

iii  Priorities and subordination

Priorities of creditors

Under the ICC, creditors who hold security rights will have a higher rank and are entitled to preferential rights over unsecured creditors. Therefore, creditors who hold security rights over land, fiduciary security, hypothec or pledge will have the highest rank, unless privileged rights are attached to the secured assets, such as unpaid taxes attached to the assets, court charges resulting from the disposal of the assets, or legal charges caused by the sale and saving of the assets. Proceeds from the sale of the secured assets must be made available first to the party that holds privileged rights, then the remainder shall be made to the secured creditors.

Priorities of competing security interests

Under Indonesian law, the priority of competing security interests will be determined by the time of registration of the security with the relevant public registry or relevant authorities. The first lender to register security rights over the secured assets will hold first priority to the security, and the second lender to register the security rights over the competing secured assets will hold second priority to the security. On enforcement of the security, the lender who holds the first priority will have a preferential right to receive the proceeds of the sale of the secured assets. The remaining proceeds of the sale will be given to the lender holding the second priority ranking.

This priority ranking of competing security interests is only applicable to security over land and a hypothec as permissible under the ICC. Other forms of securities, such as fiduciary security and pledge, are not applicable for any ranking, as the security asset cannot be granted to more than one holder.

Subordination of debts

Subordination of debts within lenders is possible to be conducted in Indonesia through contractual arrangements. This can be effected through intercreditor agreements between the lenders and, if required, the borrower. This agreement may set out priority ranking among the lenders over the secured assets.

V  LEGAL RESERVATIONS AND OPINIONS PRACTICE

i  Validity and enforceability of lending and securities

Validity of transactions

In doing transactions in Indonesia, the Indonesian Company Law and the articles of incorporation of an Indonesian company normally stipulate certain requirements to obtain corporate approval from the company organs, such as shareholders or the board of commissioners.

Under the Company Law, the board of directors must obtain shareholder approval to encumber the company assets having a value of more than 50 per cent of net assets in one transaction or more, either related to each other or not. The absence of corporate approval, when it is required, would legally affect the validity of the transaction documents, including,
in this context, loan agreements, securities or guarantee agreements, and they might then become unenforceable. This will cause the directors to be held personally liable for any loss in relation to the provision of the agreement, guarantee or security.

Therefore, it is important for lenders to take into account the provisions of incorporation documents to make sure any requirement of corporate approval is satisfied, so the security or guarantee securing the loans would be valid and enforceable. In practice, lenders would typically require the borrower to provide written confirmation on the fulfilment of such internal corporate requirements.

**Enforcement of securities**

In the case of a default, securities that grant executorial rights to the security holder can be enforced without a court judgment or court order. However, in practice, for legal certainty in the security enforcement and to avoid any challenges from other parties, a court order would be necessary.

The sale of security assets can be made through public auction. However, a private sale would be permitted if the private sale would generate a higher sale price for the creditor and the owner of the assets has consented to the private sale.

In bankruptcy proceedings, the creditors may enforce security rights against the secured assets as if there were no bankruptcy. In the case of insolvency, the lender is given time to enforce security within two months of the time the borrower is declared insolvent. If the security is not enforced after two months, the curator or receiver of bankruptcy will take over the enforcement of the security.

**Financial assistance**

In the Indonesian jurisdiction, no prohibitions or restrictions exist on conducting lending arrangements, in particular to provide financial assistance by guarantee or security to secure the loan of a party in connection with the purchase of its shares, its subsidiary or affiliate shares, provided that it is conducted within the law and its articles of incorporation. It must also be conducted with respect to the *ultra vires* doctrine, whereby the action must be conducted within the purposes and objectives of the company, and in the interests of the company. The director’s fiduciary duty must also be taken into account by ensuring that all necessary corporate approval is obtained to enable the director to conduct the transactions.

**ii Legal opinions practice**

In loan transactions in Indonesia, legal opinions are typically made to the lenders on the legal capacity of the borrower, and the validity and enforceability of transaction documents and security interests. Legal opinions are normally addressed and made available only to the lenders, and the disclosure of the opinion is typically limited to the counsel and the lenders.

**iii Choice of foreign governing law**

Choice of foreign law as the governing law is recognised by Indonesian courts as a valid choice of law in an agreement. In financing agreements, a choice of foreign governing law is not permitted for securities or guarantee agreements. These agreements must be governed by Indonesian law so that they are able to be enforced by Indonesian courts.

Foreign judgments cannot be enforced by Indonesian courts on the basis of territorial sovereignty under the Indonesian Code of Civil Procedure. To be enforced in Indonesia, cases
with a foreign judgment must be re-examined at the relevant Indonesian court. The foreign judgments may be treated as evidentiary documents; however, Indonesian courts will not be bound by the findings of the foreign court in the foreign judgments.

VI  LOAN TRADING

Loan trading is commonly effected in Indonesia by an assignment. The assignment can be perfected by the acknowledgement of the debtor on the assignment, therefore binding the debtor to fulfil its obligation to the new creditor who receives the assignment (assignee). The absence of debtor acknowledgement on the assignment will not affect the debtor’s obligation to perform its loan repayment to the first creditor, even if the assignment agreement has been executed. The debtor is entitled to choose to continue performing its obligation to the first creditor.

The assignment of debt that is secured by security interests, such as security rights over land, fiduciary security or pledges, will include its security to be assigned together with the secured debt. The assignee of the debt would benefit from receiving security rights along with the debt. For the perfection of the security rights, the assignee must notify and register the debt assignment and its security rights with the relevant public registry.

VII  OUTLOOK AND CONCLUSIONS

The government is prioritising infrastructure development in Indonesia, but so far it has been dependent mostly on the state budget and state-owned enterprises to deliver the projects. This is more than likely to change in the near future, as the government has made efforts by introducing regulatory reforms to establish a more attractive and conducive atmosphere in the coming years for international agencies and private sector finance participants in infrastructure.
I OVERVIEW

The Italian loan market is constantly growing and changing, owing to the recent reforms aimed to ensure easier access to credit for enterprises by widening the platform of licensed lenders.

In general, Italian companies rely on bank intermediation as a source of financing. However, structural and cyclical reasons led to the preference of a diversified financial system, which includes not only banks but also other kinds of intermediaries as well as the capital markets, which contribute to a significant extent to the financing of companies and enterprises in general.

In particular, recent legislation has opened the Italian loan market to other categories of participants, such as Italian securitisation companies, insurance companies, pension funds and closed-end investment funds.

In Italy, the Loan Market Association (LMA) plays an important role, especially for banks, in establishing transactions models. In 2017, the LMA announced the launch of template documents for use in Italian private placement transactions with the hope that standardisation of Italian law documentation will assist in creating a more unified and efficient private placement market. The template documents include a form of facility agreement.

II LEGAL AND REGULATORY DEVELOPMENTS

1 Recent developments affecting the lending market

Recent amendments to the Italian Securitisation Law were introduced by the 2019 Budget Law and the Growth Decree issued by the Italian government, to encourage alternative finance channels (other than banks and financial intermediaries). In particular, in addition to the provisions that allowed Italian securitisation companies to take part in lending activities in favour of small and medium-sized enterprises (i.e., enterprises with a balance sheet equal to...
or in excess of €2 million) and clarified that a special purpose vehicle (SPV) may both advance loans and purchase receivables (mixed securitisation). Other significant amendments also concern the establishment of ‘auxiliary’ SPVs, aimed at purchasing, managing and valorising real estate assets (ReoCos) or registered movable assets securing the securitised receivables, or assets leased under financial lease agreements (LeaseCos), as well as the introduction of a new type of securitisation of proceeds arising from the ownership of real estate and registered movable assets, or other rights in rem or personal rights over such assets provided that certain conditions are met. In relation to ReoCos and LeaseCos, the Growth Decree introduced provisions leading to the neutrality for, inter alia, direct tax of the proceeds and expenses derived and accrued by such companies in relation to the segregated assets. Other advantageous tax provisions have been introduced as to indirect taxation of transactions carried out by RecoCos and LeaseCos.

Other relevant developments introduced by the Growth Decree concern the securitisation of non-performing loans deriving from credit agreements. The Italian government, urged by European institutions, is intending to accelerate the process of the disposal of non-performing loans by Italian banks. To this end, the assignor bank may also transfer to another bank or financial intermediary the commitments and faculties to grant the financings arising from the credit agreements, and, at the same time, maintain the bank account related to each credit agreement on which payments are made by the borrowers.

Other incentives to alternative financial sources are provided by the Growth Decree in granting guarantees of the Guarantee Fund in favour of investors that finance projects through lending and crowdfunding platforms.

ii **Basel III, Capital Requirements Directive IV and increased costs**

After Basel III and the other global impact initiatives, access to credit has become increasingly difficult for small and medium-sized enterprises due to increasingly complex and burdensome banking rules and the high costs to adapt to the new regulations. For small and medium-sized enterprises, access to credit is not easily available and may be expensive, also in light of contractual provisions shifting transaction costs on borrowers.

iii **Sanctions and anti-corruption laws**

Generally, borrowers are usually requested to grant lenders with wide-ranging representations and undertakings in facility documentation that address sanctions and anticorruption laws specifically. However, the acceptance of these provisions and the regulation of a breach of the same represent a crucial point in the negotiation of transaction documents, considering that borrowers may be not able to monitor and comply with these provisions.

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5 According to Article 7.2(2) of the Italian Securitisation Law, (1) the SPV must exclusively carry out real estate securitisation transactions (excluding, therefore, any other transaction); (2) assets and rights that secure the rights of the noteholders and hedging counterparties must be identified; (3) the assets relating to each real estate securitisation transaction are, by operation of law, segregated for all purposes from all other assets of the SPV and from assets relating to other securitisation transactions; and (4) no actions are permitted on the segregated assets by creditors other than the noteholders, grantors of financings or the hedging counterparties.

6 The Guarantee Fund was provided by Article 2 of Law No. 662 of 23 December 1996 to partially secure the financial loans granted by Italian banks in favour of small and medium-sized enterprises.
III TAX CONSIDERATIONS

i Withholding tax on payments and deductibility of interest

Withholding tax does not apply to interest on loans paid by Italian borrowers to Italian banks, or non-Italian banks lending through an Italian branch (if non-Italian banks do not lend through an Italian branch, a withholding tax of 26 per cent is instead due). A similar regime applies to payments of interest from an Italian borrower to a securitisation issuer (being a company incorporated in Italy) and there will be no cross-border interest payment.

The withholding tax rate (where applicable) may be reduced if a treaty against double taxation is applicable.

Infra-bank deposits and loans are not subject to withholding tax.

This tax regime has been partially amended, providing that no withholding tax shall be levied on interests and other incomes deriving from medium to long-term loans if granted by the following:

- credit institutions established in EU Member States;
- entities listed by Article 2(5) (Nos. 4–23) of Directive 2013/36/EU;
- insurance companies established and authorised under regulations issued by EU Member States; or
- foreign institutional investors, established in a white list jurisdiction, subject to supervision in the foreign countries where they are established.

Starting from tax year 2019, and subject to a transitional regime, interest expenses and similar financial charges are deductible in each tax period up to the total amount of the interest income and similar financial incomes realised in the same period and reported from previous tax periods.

The excess of interest expenses and similar financial charges is deductible up to the amount of 30 per cent of the gross operating income (ROL) resulting from the same tax period and 30 per cent of the ROL reported in the previous five tax periods.

However, interest expenses incurred by insurance companies and parent companies of insurance groups, as well as by financial intermediaries, are deductible within the limits of 96 per cent of their amount.

Pursuant to the 2019 Budget Law, the limitations for the deductibility of interest expenses do not apply to interest expenses on loans secured by mortgages on rental properties incurred by property management companies.

ii Stamp and documentary taxes

The substitute tax regime

In the Italian lending practice, banks tend to benefit from the substitute tax regime. Substitute tax takes the place of any mortgage, cadastral registration, stamp or governmental concession taxes that may be payable on the documents relating to the transaction), which may achieve significant tax savings.
The substitute tax regime will apply if:

a) loans are granted by, inter alia, a lender that is either an Italian bank or an EU bank, an Italian-authorised branch of an EU or non-EU bank, or an Italian or an EU financial intermediary;7

b) the duration of the loan exceeds 18 months (i.e., it is a medium to long-term loan); and

c) the loan documentation is executed in Italy.

Substitute tax is applied even if the loan is granted by an EU non-resident bank, provided that the agreement is executed in Italy.

If all such conditions are met, the substitute tax will apply at the rate of 0.25 per cent (reduced or increased for specific types of loans), on the amounts of the loan (the taxable base being equal to the amounts drawn down by the borrower).

If the substitute tax does not apply, the tax treatment of the mortgage loan and the related security documents would be as follows.

Registration tax

As a general rule, documents providing for the granting of security concerning the grantor’s own obligations are subject to registration tax at the fixed amount of €200. However, third parties’ obligations on a gratuitous basis are subject to registration tax at the rate of 0.5 per cent.

The general rule is that registration tax will be calculated and paid on the secured amount.

If a consideration is paid for the granting of security or giving of guarantees by the relevant party, the granting of the security is subject to value added tax (VAT), but exempted from the payment of such tax and subject to registration tax at the fixed rate on the basis of the principle of alternative applicability between VAT and proportional rate registration tax. This solution, however, is not used much in practice, since there is the risk that the tax authorities recharacterise the transaction as a non-VAT transaction if the consideration is nominal.

Mortgage and cadastral taxes

Mortgage tax shall be due at a maximum rate of 2 per cent of the secured amount to be paid for the mortgage registration upon the filing of the relevant application.

Cadastral tax shall be due at the rate of 1 per cent of the value of the mortgaged assets.

Stamp duty

Stamp duty would generally apply at the fixed amount of €16 for each four pages of each security or guarantee document.

iii Foreign Account Tax Compliance Act

The Foreign Account Tax Compliance Act was signed on 10 January 2014 between the United States and Italy through an intergovernmental agreement. At present, its domestic
implementation has occurred through relevant legislation (Law No. 95 of 18 June 2015 and the Decree of the Ministry of Economics and Finance of 6 August 2015) and several regulations issued by the competent Italian authority.

IV CREDIT SUPPORT AND SUBORDINATION

i Security

Forms of security interests

Lending transactions are typically followed by a combination of security interests. Accordingly, Italian law offers a wide range of legal arrangements, meant to ensure the debtor’s solvency. Security documents are invariably entered into in writing. In many cases, this is a legal requirement; in other cases, this is done anyway to prevent the guarantor from raising any questions about the existence of the guarantee. The most common forms of in rem security interests are privilege, pledge and mortgage.

Privilege

In broad terms, the law grants a privilege over the generality of a debtor’s movable assets or the debtor’s specific assets in favour of a specific credit because of legal purposes and the nature of said credit. As a consequence, the person entitled to the credit is entitled to satisfy in priority compared with other creditors over the proceeds of a given asset (pre-emption right). A privilege also gives the creditor a right of subrogation and a right of retention.

The law establishes the order of different privileges on the same asset, and the relationship between privilege and mortgage, as well as the relationship between privilege and pledge.

Special privilege pursuant to Article 46 of the Italian Banking Act

This special privilege is a lien available to secure debt claims under medium or long-term loans (over 18 months) granted to entrepreneurs by banks authorised to carry on banking business in Italy.

A special lien can be granted by a written document (describing, inter alia, the assets over which the lien is granted, and the amount and terms of the secured loan) but will only be effective regarding third parties once the special privilege is registered in a special register kept in the clerk’s office of the court of the place in which the borrower’s registered office is located, and, as the case may be, of the place in which the third party granting the special privilege has its registered office.

Pledge

Under Italian law, a pledge is a security on movable properties, which is normally perfected when the pledged asset is delivered to the pledgee, although the dispossession of the pledgor is not always necessary and can be avoid under certain conditions. A pledge may also be given by a third-party pledgor.

A pledge gives the pledgee a pre-emption right over the proceeds of the pledged asset but does not allow the pledgee to dispose of the pledged asset.

A pledge requires a written agreement, with the date certain at law.
Non-possessory pledge
A non-possessory pledge, which has been recently introduced in Italy, allows the pledgor, who is engaged in entrepreneurial activities, to keep hold of the pledged asset and continue to use it for business purposes. In this perspective, a link to the relating entrepreneurial activity of the pledgor is necessary for the pledge to be valid.

By keeping possession of the assets, the pledgor has the chance to transform, transfer or otherwise dispose of them. Accordingly, the pledge would extend to any asset resulting therefrom.

A non-possessory pledge agreement requires a written form and shall indicate a maximum secured amount. However, the pledge is enforceable regarding third parties only upon registration on an electronic register of non-possessory pledges, to be set up within the Italian Revenue Agency. The pledge, in addition, will rank according to the time of registration with the electronic register, except for a special derogation in favour of those pledges (ordinary and non-possessory) granted as collateral for a loan, which prevail over the non-possessory pledge previously registered.

Foreclosure proceedings are in this case far simpler than the ordinary proceeding described by the Civil Code, allowing the creditor to protect his or her rights in several ways.

Pledge over shares of a joint stock company
A pledge over shares is valid if granted by a written document bearing the date certain at law, which specifically describes the receivable and the shares covered by the pledge. The share pledge is perfected by either endorsing the share certificate by way of a pledge or by entering the pledge in the share certificate and, in either case, by entering the pledge in the shareholder’s book.

Specific rules apply to pledges over dematerialised shares.

The voting rights in the pledged shares are transferred to the pledgee on execution of the pledge. However, it is open to the parties to agree otherwise.

Pledge over quotas of a limited liability company
Under Article 2471 bis of the Civil Code, a debtor may grant a pledge over a limited liability company, namely a pledge over the rights of a quotaholder corresponding to its quota interest in the company. Quota pledges are granted by a notarised private writing and are perfected by entering the pledge in the Register of Enterprises and, where relevant, in the quotaholder’s book. The legal regulation of voting rights is basically the same as for a pledge over shares of a joint stock company.

Mortgage
A mortgage over real property gives the lender a right to foreclose on the specific property made liable to secure its identified claim, even against a third-party transferee; and a preference in being paid from the proceeds of the foreclosure. Mortgages will have different rankings, depending on the date of registration. A mortgage may also be given by a third-party mortgagor. A mortgage may also be granted on assets that the mortgagor does not currently own (in this case, the mortgage can be validly perfected only upon acquisition of the asset by the mortgagor) and on future assets (in this case, it can be validly perfected only upon the asset coming into existence).

A mortgage may be granted by either a unilateral deed or a bilateral agreement. In any case, the mortgage deed must be made in the form of a public deed or a written document.
with signatures certified as true by a notary public or other authorised public officer. If these formalities are not followed, the mortgage cannot be registered and therefore is not validly created. The instrument granting a mortgage must specifically designate and describe the immovable property involved and the secured amount.

The mortgage is perfected (for 20 years and subject to further renewals) and enforceable regarding third parties upon registration in the public register of immovable property of the place in which the immovable property is situated (the local land or property registry).

The details contained in the mortgage register would need to be amended if any changes occur in the parties secured by the mortgages, except for transfers made pursuant to Article 58 of the Italian Banking Act or pursuant to the Italian Securitisation Law to another bank authorised in Italy, as the formalities set out therein for a transfer to be effective regarding third parties will take the place of any other formalities to the same effect.

If the property over which the mortgage is granted and registered is transferred, the mortgage will also be transferred, but the third-party purchaser will either have the right to release the property to the secured creditors or pay to the creditors an amount determined pursuant to the applicable provisions of the Civil Code; but in the second case, the secured creditors will have the right to start foreclosure proceedings on the property, subject to certain conditions being met.

In addition to the general legislation applicable to mortgage lending, Italian mortgage loans over real property may fall within the provisions of a specific legislation. If a loan qualifies as a fondiario mortgage loan (as defined by Article 38 of the Italian Banking Act), certain material advantages are granted to the lending bank, namely advantages against certain restrictions on enforcement and other advantages to the borrower.

Forms of personal guarantees

The following forms of guarantees are commonly used in financing transactions: joint and several guarantees; and first demand ‘autonomous’ guarantees.

A joint or several guarantee is an undertaking by a guarantor to pay a debt if the debtor fails to do so. These guarantees are usually given on a joint and several basis by the guarantor and the debtor, allowing the creditor to choose whether to pursue its claim against either or both of the guarantor and the debtor (unless the parties have agreed that the guaranteed creditor shall claim payment from the principal obligor first). When future claims are guaranteed, the joint or several guarantee shall indicate a cap.

A first demand autonomous guarantee differs from a joint or several guarantee in that it is an independent undertaking, and therefore the guarantor is obliged to pay under the guarantee as a principal obligor and on demand from the beneficiary, regardless of any defence of the primary debtor.

Other matters relevant to security

In a cash flow securitisation made pursuant to the Italian Securitisation Law, the assets relating to each securitisation transaction will, by operation of law, be segregated for all purposes from all other assets of the issuer company that purchased the receivables and from those relating to other separate securitisation transactions carried out through the same issuer company. More particularly, prior to a winding-up of the issuer company, the assets will only be available to holders of the notes issued to finance the acquisition of the relevant receivables and to certain creditors claiming payment of debts incurred by the issuer company in connection with the securitisation of the relevant assets.
In addition, the assets relating to a particular transaction will not be available to holders of the notes issued to finance any other securitisation transaction carried out by the issuer company or to general creditors of the issuer company.

Because of these provisions of the Italian Securitisation Law, it is not necessary for an issuer company created in accordance with Article 3 to grant security interests over the receivables purchased by it in favour of the holders of the notes issued by it.

However, under Italian law, any creditor of the issuer company would be able to commence insolvency or winding-up proceedings against the issuer company in respect of any unpaid debt, and the enforceability of ‘non-petition’ covenants is not clearly established.

The segregation-related provisions are enforceable before and after insolvency, subject to the limitations contained in the law generally. However, the provisions of the Italian Securitisation Law concerning the segregated assets are not likely to apply in circumstances where the cash flow referred to above is commingled with the assets of a subject other than the issuer (e.g., the originator). Thus, if any such subject becomes insolvent, the cash flow held by it could not be included in the segregated assets.

**Quasi-security devices**

Types of quasi-security devices include the following:

\( a \)  the duty of care agreement. This agreement is entered into between the lender and the asset manager, whereby the latter undertakes, inter alia:

- to duly manage the property in a manner that would not result in the borrower’s violation of the terms of the mortgage loans;
- to notify the lender of material breaches by any tenants of the leased assets, of any new lease and of the termination of any existing lease;
- to notify the lender of any damage to the property; and
- to notify the lender of any termination of the management agreement; and

\( b \)  endorsement of the insurance policies whereby the lender is named as an additional insured party and is vested with certain additional rights in respect of the insurance policies, such as that of:

- being notified of any failure by the borrower to pay insurance premiums and the related right to cure the borrower’s default;
- maintaining the insurance coverage until a given period has passed after receipt from the insurer of the above notification; and
- being paid any indemnity otherwise due to the borrower (a loss payee clause) (this is less common in the case of third-party liability insurance).

\( ii \)  Subordination

In general terms, subordination means that one creditor or group of creditors (the junior creditors) will not be paid by a borrower or other common debtor until another creditor or group of creditors (the senior creditors) have been paid.

In banking transactions, it generally takes the form of a contractual subordination, whereby the order and ranking of the debt is arranged by the creditors (usually through an intercreditor or subordination agreement).
V LEGAL RESERVATIONS AND OPINIONS PRACTICE

i Main legal reservations

Capacity and corporate benefit

Generally, the granting of security by Italian companies is restricted by the financial assistance rule (see below) and corporate benefit of the guarantor. In addition, the transaction shall be permitted by the company’s articles of association. Though a corporate benefit for a downstream guarantee is usually self-evident, this may not always be true in the case of an upstream or cross-stream guarantee.

The corporate benefit must be carefully evaluated and determined by the company’s directors (to this end, a cap of the guarantee can be provided).

Financial assistance

Until the implementation of EU Directive 2006/68/EC by Legislative Decree No. 142 of 4 August 2008 (the Decree), Italian companies were prohibited from granting loans or credit support to a third party acquiring, or subscribing to, their own shares (financial assistance), except for those transactions carried out to promote the purchase of the shares by the employees of the company, or its parent or subsidiary. The entering into force of the Decree has allowed joint stock companies to provide financial assistance for the purchase and subscription of their own shares, subject to compliance with certain conditions and the special procedure (inspired by the ‘whitewash’ Anglo-Saxon model) set out by the Civil Code. In particular, the amount of financial assistance granted by the companies shall not exceed the sum of their net income, retained earnings and other distributable reserves as set out in their latest financial statements. However, the Decree did not amend the provisions regulating the financial assistance for limited liability companies, which are, therefore, subject to the financial assistance prohibition.

Clawback risks

In the context of a bankruptcy procedure, the receiver is given powers to ‘restore’ the economic and financial substance of the bankruptcy estate to its pre-insolvency state by setting aside transactions or clawback payments, or both. These powers are limited, inter alia, to guarantees and securities granted or payments made within a certain period (six-month, one-year or, with respect to a gratuitous act, two-year periods, as the case may be, prior to the declaration of bankruptcy). 8

A special 10-day clawback period applies to mortgages securing the fondiario loans that are hardened after 10 days of their registration.

ii Legal opinions practice

Legal opinions have become standard practice in Italian law secured lending transactions. In general, legal counsel to the borrower delivers legal opinions on status, capacity and authority

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8 According to Article 166 of Legislative Decree No. 14 of 12 January 2019 (published in the Official Gazette of the Italian Republic No. 18 of 14 February 2019), which will enter into force on 15 August 2020, the ‘suspect period’ will take effect prior to the deposit of a bankruptcy petition, instead of ‘the declaration of bankruptcy’.
of each borrower and guarantor. However, legal counsel to the lender delivers legal opinions on the validity and enforceability of the facility and security package documents, and the enforceability of security interests.

**Foreign governing law**

Generally, Italian courts would uphold a choice of foreign governing law made by the parties according to the Rome I Regulation ((EC) 593/2008) on the law applicable to contractual obligations, provided that the choice is not fraudulent and the application is not manifestly incompatible with the public policy of the forum, or overrides the mandatory provisions of the forum. The parties can select the law applicable to the whole or to only part of the contract.

Final judgments obtained in a Member State from 10 January 2015 are enforceable in Italy without the need of a declaration of enforceability according to Brussels 1* bis* Regulation ((EC) 1215/2012). In addition, if no bilateral treaty applies, enforceability in Italy of final judgments obtained in a foreign (non-EU Member State) court is also governed by Title IV of Law No. 218 of 31 May 1995 (a reform of the Italian system of private international law).

**VI LOAN TRADING**

In the interbank loan market, loans are generally transferred via the procedure set out in Article 58 of the Banking Act, which provides that, inter alia, the transferee shall be a bank or a financial intermediary, or an Italian securitisation company or an authorised fund.

Pursuant to Article 58 of the Banking Act, the assignment of the loans will be effective regarding third parties upon registration of the assignment agreement with the competent register of enterprises and publication of a notice of the assignment in the Official Gazette, thus achieving a significant procedural simplification and reduction of costs.

Furthermore, transfer of any guarantee or security granted in respect of the assigned receivables is perfected by the same registration and publication. This means that no additional formality is required to such effect, which also results in a significant tax saving. In the absence of these conditions, a loan is transferred by way of either transfer of contract (which requires the consent of the borrower) or transfer of receivables.

**VII OUTLOOK AND CONCLUSIONS**

The new amendments and provisions introduced over the past few months by the 2019 Italian Budget Law and the Growth Decree have clearly shown the intention of the Italian legislator to foster the disposal of non-performing loans from banks’ balance sheets, thus reducing timing and costs (including tax relief) of these transactions owing to the opportunity for investors to acquire and manage, through SPVs, the receivables and, at the same time, own and manage real estate and registered movable assets through one or more auxiliary SPVs. Real estate securitisation transactions have also been permitted.

From a legal and economic point of view, a positive reaction is expected from the credit system, considering that these new provisions have the purpose to ease the disposal of unlikely to pay receivables, even if uncertainties still remain. Therefore, to boost this trend of development of the lending market, it is reasonably expected that further amendments and clarifications will be introduced by the conversion into law of the Growth Decree.
I OVERVIEW

The current administration has adopted ‘Abenomics’ – an accommodative monetary policy that has strengthened the lending appetite of Japanese financial institutions. As at the end of 2018, the value of outstanding loans held by Japanese banks exceeded ¥498 trillion, compared with ¥485 trillion and ¥478 trillion as at the end of 2017 and 2016, respectively. Competitive market dynamics have enabled borrowers to take out loans at relatively low interest rates and lending fees.

Banks play a central role in the Japanese loan market. The most sizable among them are three mega banks (Mizuho, MUFG and SMBC), which, together with Resona and Resona Saitama, account for 39.8 per cent of the outstanding loan balance as at the end of 2018. Other players include non-bank money lenders, private investment funds and government-related financial institutions.

Syndicated lending has been a main source of finance for companies in need of large amounts of money, and the model syndicated loan agreement published by the Japan Syndication and Loan-Trading Association is generally used as the basis of the documentation for syndicated loans. The Loan Market Association, the Loan Syndications and Trading Association, the Asia Pacific Loan Market Association and other international standardised forms are used mainly in cross-border transactions.

Given the wide availability of senior facilities, the role of high-yield and mezzanine facilities is somewhat limited. However, high-yield and mezzanine debt remains popular for borrowers seeking to stretch debt capacity in structured transactions, such as leveraged buyouts and real estate acquisitions. Mezzanine debt is typically provided in the form of subordinated loans or preferred shares.

II LEGAL AND REGULATORY DEVELOPMENTS

The fintech movement is one market trend. With respect to lending and investment, crowd funding, social lending and transaction lending are prime examples, all of which seek to match investors with borrowers who have not previously had access to conventional finance. The Banking Act, the Payment Service Act and other financial regulations have been amended to accommodate these new fintech services.

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1 Hiroki Aoyama is a partner and Keigo Kubo is an associate at Mori Hamada & Matsumoto.
2 www.zenginkyo.or.jp/stats.
3 ibid.
In addition, the amendment to the contract law provisions of the Civil Code was passed by the Diet in May 2017, and will come into effect in April 2020.

Japanese banks and other financial institutions have already started to prepare for the implementation of Basel III. For example, banks are looking to liquidate their long-standing loan receivables, such as project finance loans, to decrease their risk assets. Therefore, the full implementation of Basel III is not expected to have a serious impact on Japanese financial institutions.

III TAX CONSIDERATIONS

With respect to corporate tax, interest paid by a Japanese borrower is generally deductible from the taxable income of the borrower. As an exception to the general rule, some part of the interest paid to a non-Japanese lender with a close relationship to the borrower may not be deductible under limited circumstances; that is, when (1) the interest paid is excessive compared with the arm’s-length rate (transfer pricing); (2) the debt is considered to have been provided instead of a capital contribution (thin capitalisation rule); or (3) the parties grant loans to, and receive interest from, each other in an arbitrary manner (earnings stripping rule).

Lenders are subject to corporate tax, depending on their status. International lenders should note that, in Japan, the tax treatment of their income from loans depends on whether the profit relating to the loan arises from a permanent establishment in Japan.

Cross-border interest payments of Japanese borrowers are subject to Japanese withholding tax, subject to certain exemptions. Unless otherwise provided in an applicable tax treaty, the tax rate is 20.42 per cent.

Written loan agreements are subject to stamp duty. The amount of duty depends on the amount loaned and the nature of the loan transaction (such as whether the loan is a term loan or a commitment line). The maximum amount of duty is ¥600,000 per document.

Other taxes and charges that may be relevant to a loan transaction include registration fees and notary fees for the perfection of security interests.

All Japanese financial institutions are required to register with the Internal Revenue Service as foreign financial institutions and observe the Foreign Account Tax Compliance Act (FATCA). On the assumption that Japanese financial institutions observe FATCA, they are exempted from the withholding tax obligation thereunder. Thus, domestic loan documentation typically does not refer to FATCA.

IV CREDIT SUPPORT AND SUBORDINATION

i Security

Taking security generally

The concept of a 'universal' security interest for loans (whereby a security interest over all of the debtor’s properties, whether present or after-acquired, is granted to the lender) does not exist under Japanese law. Thus, the assets provided as security must be specified in the security documents, and different procedures and requirements for the creation and perfection of security interests apply to different categories of assets (such as real estate, movables and receivables).

In addition, there are peculiar issues with respect to creating a security interest for a group of secured parties (such as syndicated lenders).

These are explained further below.
Real estate
Among the forms of security available under Japanese law (i.e., mortgage, pledge and security assignment), a mortgage is typically used for real estate. The secured obligations can be specified (fixed mortgage) or designated as a certain group of unspecified obligations (blanket mortgage).

A mortgage is perfected by registration at the legal affairs bureau with jurisdiction over the location of the property. The registration fee is 0.4 per cent of the amount of the secured obligation. To reduce the upfront cost, some lenders permit the security provider to make a provisional registration only, on day one, which costs ¥1,000 per property. Once the mortgage is provisionally registered, the priority is reserved for the mortgage over subsequent competing parties, such as other mortgagees. However, provisional registration is of little use unless formal registration is completed. To upgrade from a provisional to a formal registration, documents (some of which must be provided by the security provider) must be submitted and registration fees (which are typically borne by the security provider or the borrower) must be paid. Therefore, a lender needs to consider how to secure the necessary documents and costs until the mortgage is formally registered. Typically, a security provider is obliged to submit and update the necessary documents in the lenders’ custody and to upgrade to a formal registration before or upon the occurrence of certain trigger events (e.g., breach of any financial covenants or the occurrence of an event of default).

Movable properties
Pledge and security assignment (also known as security by way of assignment or assignment for the purpose of security) can be used to constitute a security over movable properties. Actual delivery of the property is required to effectuate a pledge over movable property. For this reason, security assignment is more often utilised since it does not require actual delivery. The secured obligations can be specified obligations or designated as a certain group of unspecified obligations. Subject properties can be individual properties or a pool of properties. The pool needs to be sufficiently identified by specifying the type of asset, the location and other necessary criteria. This method enables lenders to capture after-acquired movable properties as security.

To perfect a security assignment of movable property, actual or constructive delivery of the subject property (such as an occupant’s manifestation of its intent to occupy the subject assets on behalf of the secured parties) is required. Alternatively, registration of the transfer will also perfect the security assignment. The registration fee is ¥7,500 per filing, in addition to the professional fees of the judicial scrivener.

Aside from the above, special requirements apply to certain categories of movable property, such as aircraft and automobiles.

Receivables
Pledge and security assignment are the most typical forms of securities for receivables. The secured obligations can be specified obligations or designated as a certain group of unspecified obligations. Future (after-acquired) receivables can be subject to a pledge or security assignment, provided that the target receivables are sufficiently identified.

Lenders can perfect the pledge or security assignment by giving notice to, or obtaining consent from, the obligor in written form with a notarised date certificate. Alternatively,
registration of the pledge or transfer will also perfect the pledge or security assignment. In most cases, the registration fee is ¥7,500 per filing, in addition to the professional fees of the judicial scrivener. The cost of a notarised date certificate is even lower.

Receivables cannot be collateralised without obtaining the obligor’s consent if the underlying contract has a transfer restriction clause. One type of receivable with a contractual transfer restriction is a bank deposit. Banks are generally reluctant to give consent unless the bank is one of the secured parties.

**Shares**

Pledge is the most typical form of security for shares. The secured obligations can be specified obligations or designated as a certain group of unspecified obligations.

The method for perfection depends on the types of shares. If the shares are dematerialised, the pledge is perfected by means of electronic book entry. If not, the share pledge is perfected by the delivery of the share certificate representing the pledged shares. If the shares are not dematerialised and share certificates are not issued pursuant to the articles of association of the issuing company, the share pledge is perfected by recording the pledge in the shareholder ledger.

Even if the articles of association of the issuer contain transfer restrictions, a share pledge can be constituted by an agreement between the pledgor and the pledgee. However, lenders sometimes request that the target company amend its articles of association to remove any hindrance to the enforcement of the pledge.

**Intellectual property**

Pledge and security assignment are available forms of security for intellectual property, such as patents, trademarks, design rights and copyrights. A security assignment can be perfected by registration at a low cost – only ¥30,000 or less per right, whereas the cost of registration of a pledge is 0.4 per cent of the amount of the secured obligation. One disadvantage of constituting a security assignment is exposing the secured party to a lawsuit for infringement, because the secured party becomes the legal titleholder to the intellectual property.

**Others**

The creation and perfection of security interests over other types of assets (such as factory foundations, debt securities and trust beneficial interests) are covered by the rules applicable to each type of asset.

**ii  Taking security for a group of lenders**

Traditionally, as a generally accepted principle of Japanese law, security interests must be held by the holders of secured obligations. Therefore, all lenders (rather than a single security agent or security trustee) are secured parties in most syndicated loan transactions. This sometimes leads to burdensome procedures when there is a transfer of loans or collective enforcement of security interests.

The security trust structure is an alternative to the traditional approach. After the amended Trust Act of Japan introduced the concept of a security trust in 2007, it became clear that a security trust can be utilised under Japanese law. In practice, however, security trusts have not been very frequently used, partly due to the increase in transaction costs because of fees payable to the licensed security trustee and complex documentation.
Another alternative is the use of a parallel debt structure, where a security agent holds security interests to secure parallel debts owed to it by the borrower, rather than to secure loan obligations owed to each lender. Although the concept of parallel debt is novel to the Japanese legal community and there are no reported domestic transactions using a parallel debt structure governed by Japanese law, it is theoretically feasible to create a parallel debt structure under Japanese law.

iii Guarantees and other forms of credit support

Guarantees are commonly used for credit enhancement. There are no specific statutory limitations or restrictions on parent guarantees for its subsidiary (downstream) or subsidiary guarantees for its parent company (upstream). However, there is an issue with upstream guarantees due to the general fiduciary duty owed by the guarantor’s directors. If a subsidiary provides an upstream guarantee solely for the benefit of a majority shareholder (owning less than 100 per cent of the shares in the guarantor), and there is no corporate benefit to the subsidiary in providing such guarantee, the directors of the subsidiary may be accused of breaching their fiduciary duties. To avoid this risk, in practice, subsidiaries usually refrain from providing upstream guarantees unless the consent of the minority shareholders has been obtained. The same applies to upstream security, whereby a subsidiary provides security to its parent company’s lenders.

In terms of quasi-security arrangements, negative pledge undertakings are widely used in loan transactions in Japan. A typical loan agreement also allows the lenders to exercise set-off rights against the borrower’s cash deposits in its bank accounts opened with the lenders. Banks’ rights of set-off are strongly protected in that banks are, in principle, entitled to set-off even after a third party seizes the borrower’s bank deposit or the borrower goes bankrupt.

iv Priorities and subordination

Several methods of subordination are used in the Japanese loan market. Aside from structural subordination (which involves borrowing entities at different levels, where the subsidiary borrows senior debt and the parent borrows subordinated debt), there are two types of contractual subordination structures: absolute subordination and relative subordination.

Under an absolute subordination arrangement, if the borrower becomes insolvent, the payment of subordinated debt is contractually made conditional upon the full payment of the senior debt. Thus, senior lenders ensure that the subordinated lender does not receive payment in priority to, or at the same ranking with, the senior lender.

The essence of a relative subordination arrangement is an intercreditor agreement between the senior and subordinated lenders. Typically, the subordinated lenders agree to turn over any payment they receive from the borrower to the senior lenders until the senior debt is paid in full, with certain exceptions of permitted payment. This type of arrangement is not intended to bind the insolvency trustee in the case of the borrower’s insolvency. If the borrower is insolvent, the insolvency trustee may disregard the intercreditor agreement and make distributions proportionate to the loan amounts held by the senior and subordinated lenders. Senior lenders then have to rely on the subordinated lenders to turn over the distributions to the senior lenders to uphold the priority of the senior debt.

Despite this disadvantage, senior lenders, as well as subordinated lenders, sometimes prefer relative subordination rather than absolute subordination. This is because a relative subordination arrangement could lead to greater distribution to senior lenders if the distributions are turned over by the subordinated lenders. Under absolute subordination,
by reason of the condition attached to the subordinated debt, subordinated lenders may not participate in any distribution from the insolvency estate until the unsecured portion of the senior debt, if any, is paid in full. This means that the subordinated lenders are subordinated not only to the senior lenders but also to the general unsecured creditors, such as trade creditors, whose claims rank *pari passu* with the unsecured portion of the senior debt.

The ranking and priority of competing security interests are determined by reference to the timing at which each security interest is perfected, or the first perfected security is given first priority. Therefore, as a matter of ranking of the security interests, subordination can be created by perfecting the subordinated lender’s security after the perfection of the senior lender’s security.

Regarding some types of assets, however, there are technical difficulties in creating several security interests with different rankings. For example, it is theoretically unclear whether there can be multiple security assignments at different rankings over one property (unlike multiple pledges giving rise to no such issue). Moreover, the book-entry system does not accept multiple pledges over dematerialised shares. Under security trust and parallel debt structures, these issues can be avoided by creating one security assignment or pledge held by a security trustee or security agent. Otherwise, senior lenders and subordinated lenders need to agree to a special contractual arrangement to circumvent these technical difficulties, or the subordinated lenders simply give up taking security over these types of assets.

V LEGAL RESERVATIONS AND OPINIONS PRACTICE

Insolvency avoidance is a notable risk for secured lenders. The creation of a security interest by a financially distressed borrower may be invalidated (by the insolvency trustee or the debtor-in-possession) if the security interest was created to secure existing debt:

a. either after the filing of an insolvency petition against the borrower (and the creditor knew that the petition had been filed);

b. during the period when the borrower is ‘unable to pay’ (i.e., unable to pay its debts generally when they fall due) and the creditor knew that the borrower was unable to pay, or that the borrower did not pay, its debts generally when they fell due; or

c. 30 days or fewer before the borrower became ‘unable to pay’, and the borrower voluntarily created the security interest in favour of a specific creditor (and the creditor knew that the creation of the security would prejudice other creditors).

The perfection of a security interest may also be avoided even where the creation of the security interest itself may not be avoided. This is to prevent an invisible secured creditor from obtaining priority over general creditors after the borrower becomes financially distressed. The requirements of such avoidance include the perfection being made after the suspension of payments or the filing of an insolvency petition, and not being made within 15 days of the creation of the security interest.

Obtaining a guarantee or receiving payment may be avoided under certain circumstances. In connection with a subsidiary providing an upstream guarantee or security interest for its shareholder, there is an issue regarding the fiduciary duty of the guarantor’s directors, as explained in Section IV.ii. However, a wholly owned subsidiary often provides a guarantee and security interest in favour of the lender of the parent. This is also the case in the context of leveraged buyouts. Although it may not be entirely free from academic discussion, it is common practice in Japan for a target company to provide a guarantee and security interest...
to secure loan facilities taken out by the acquisition vehicle to finance its acquisition of the
shares in the target, as long as the acquisition vehicle wholly owns the target at the time of
provision of the guarantee and security interest.

As to the opinions practice in Japan, domestic lenders do not usually require a legal
opinion in connection with simple corporate loan transactions. However, when the loan
transaction involves some complexity (e.g., in the case of project finance, acquisition finance,
asset-backed finance or international transactions) lenders usually require a legal opinion.
The borrower’s counsel, rather than the lender’s, normally issues a legal opinion addressed
to the agents and lenders. Disclosure of the opinion to a third party is made subject to
the consent of counsel, with occasional exceptions of the disclosure being permitted to a
participating lender or a supervisory authority on a non-reliance basis.

In line with international practice, a Japanese law opinion is rendered with several
assumptions, qualifications and limitations. As one of the common qualifications peculiar
to Japan, the opinion on the validity and perfection of security interests over ordinary (not
fixed-term) bank deposits is usually limited or not given at all. This is because of an old
court decision that denied the validity of such security interests, although today’s leading law
professors are unanimously supportive of its validity and most practitioners agree to their
view. Likewise, opinions on security interests over shares in a limited liability company, a
summary type of corporation, is usually limited or not given at all as well. This is due to the
lack of clear statutory provisions or court rulings.

Japanese courts generally recognise the validity of a choice of a foreign law as the
governing law of a contract, but the governing law of security interests cannot be chosen
by the parties. For example, security interests over real estate and movable properties are
governed by the law of the location of the subject properties.

Japanese law adopts the principle of reciprocity regarding the recognition of foreign
judgments. As such, Japanese courts will recognise final and conclusive civil judgments
rendered by a foreign court if:

a. the foreign court has jurisdiction over the matter based on relevant laws or treaties;
b. the unsuccessful party received due service of process or appeared in court;
c. the content of the judgment and the related court proceedings are not contrary to the
   public order and good morals of Japan; and
d. there exists reciprocal recognition between the relevant foreign jurisdiction and Japan.

Japan is a party to the New York Convention (1958) and the Geneva Conventions (1927).
Therefore, to the extent these conventions are applicable, the recognition of a foreign arbitral
award is determined in accordance with these conventions. Otherwise, recognition of a
foreign arbitral award is determined based on the same requirements applicable to a domestic
arbitral award under the Arbitration Act. Those requirements are as follows:

a. the award must be final and conclusive;
b. the parties must have received due service of process and been afforded the opportunity
to defend themselves;
c. the award must have been given in accordance with the law of the location of the
   arbitration; and
d. the contents of the arbitral award must not be contrary to the public order and good
   morals of Japan.
VI  LOAN TRADING

The most common transfer mechanism in the secondary loan market is the outright transfer of loan receivables. A loan receivable can be transferred without the borrower's consent unless the relevant loan document provides otherwise. The benefit of the associated security package can be transferred with or without the consent of the security provider and other lenders, depending on the nature of the security interests, such as whether the security interest is a fixed security or a blanket security. Many loan documents oblige the security providers, subject to certain conditions, to cooperate with the secondary transaction by giving consent to the transfer of the security interest.

Another secondary mechanism is participation. Under a participation arrangement, the loan receivable and security package does not legally transfer to the participant. As such, the participant benefits indirectly from the security package via the lender's enforcement. Under Japanese law, unlike New York law participation, the participant is exposed to the credit risks of the existing lender as well as the borrower. In the event of an insolvency of the existing lender, the participant has a contractual claim against the existing lender for the amounts owed by it under the participation agreement.

VII  OTHER ISSUES

There are usury laws in Japan. Although multiple acts address this issue in a complex manner, the most notable regulation is that the maximum interest rate for loan transactions is 15 per cent where the amount loaned is ¥1 million or greater.

Usury laws provide that fees or other monies paid to a lender in respect of a loan are deemed to be interest for the purpose of the usury laws. In this context, the scope of ‘deemed interest’ often becomes a practical issue. First, under the Commitment Line Act, commitment fees are statutorily exempted from the scope of deemed interest provided that the borrower falls within the prescribed categories, such as a stock corporation with a share capital of ¥300 million or greater. Second, whether other fees such as arrangement and agent fees fall within the scope of deemed interest has, at times, been a critical issue. The practitioners’ approach to this issue is, put simply, that provided that the independent and substantial services (such as arrangement services) are provided and the amount of fees is within a reasonable range for such services, the fees should not fall within the scope of deemed interest.

VIII  OUTLOOK AND CONCLUSIONS

The Civil Code amendment, taking effect in April 2020, is the first fundamental amendment to Japanese contract law since its enactment in 1896. One of the most significant amendments is limiting the effect of contractual transfer restrictions on receivables (with the exception of bank deposits). Under the amended contract law, a receivable with a contractual transfer restriction can, in principle, be transferred, pledged and assigned as security even without obtaining the consent of the obligor. Although careful risk analysis of the new and complicated rules is needed, some practitioners see new possibilities of secured transaction utilising receivables as collateral.

In terms of the loan market generally, the interest rate in Japan has been low for a long time. This has made it difficult for banks and other financial institutions to accomplish high profitability in the conventional lending business. Financial institutions are seeking new investment opportunities, and market participants may see lending activities taking place in a new sphere.
I OVERVIEW

Luxembourg is generally perceived as one of the most attractive business centres in the world. With approximately 140 registered banking institutions, more than €4,300 billion of assets managed by more than 4,000 undertakings for collective investment, a successful private equity industry and a dynamic insurance sector, Luxembourg offers a full range of diversified and innovative financial services.

The financial sector remains Luxembourg’s main growth engine, accounting for nearly one-third of GDP and directly employing 44,000 full-time equivalents, which corresponds to approximately 12 per cent of Luxembourg’s labour force.

Although the main activity of Luxembourg banks is international financial intermediation, private banking is an important pillar of the financial industry. It is the largest in the eurozone and is ranked sixth in the world. Luxembourg has been assigned ‘AAA’ credit rating by the main rating agencies.

The move towards greater consolidation in the banking sector, which surfaced in recent years, has become one of the key features of the financial landscape in Luxembourg. Market players have to deal with mergers, restructurings and closing of lines of business.

The Luxembourg lending market is characterised by a growing presence of alternative credit providers. Luxembourg has the advantage of an experienced regulatory authority, the Luxembourg Financial Supervisory Commission (CSSF), which has clarified certain exemptions for Luxembourg lending platforms.

In recent years, Luxembourg has taken major initiatives to further increase its attractiveness, such as the development of a sophisticated fintech industry, the creation of an important offshore Chinese renminbi hub, and the furtherance of Islamic finance projects and green bonds issuances.

Recent trends and legal developments offer the Luxembourg financial sector excellent growth opportunities. Particular points of interest are the lender-friendly security interest regime, the Luxembourg Act of 27 July 2003 on the trust and on fiduciary contracts, as amended (the Fiduciary Act 2003),

1 Henri Wagner is a partner and François Guillaume de Liedekerke is counsel at Allen & Overy.

2 Mémorial A – No. 124 of 3 September 2003.
II LEGAL AND REGULATORY DEVELOPMENTS

i Security interests

In the aftermath of the economic crisis and the financial markets turmoil in 2008, financial collateral arrangements have attracted considerable attention from market participants. The Luxembourg Act dated 5 August 2005 on financial collateral arrangements, as amended (the Collateral Act 2005), provides for an attractive legal framework for security interests, liberalised rules for creating and enforcing financial collateral arrangements, and protection from insolvency rules. It applies to any financial collateral arrangements, irrespective of the nature of secured liabilities or the status of the pledgor or the pledgee, and covers financial instruments in the widest sense as well as cash claims and receivables.

The Collateral Act 2005 was amended in 2011 with a view to enhance the attractiveness of Luxembourg as an international finance centre. It now confirms that the insolvency safe harbour provisions also apply to foreign law-governed collateral arrangements entered into by a Luxembourg party, which are similar to the Luxembourg financial collateral arrangements. It provides that receivables pledges are validly created among the contracting parties and are binding against third parties as from the date of entering into the pledge agreement. It also modernised the enforcement mechanism by allowing the collateral taker to appropriate, out of court, the pledged assets at a price determined after the appropriation of the asset and to direct a third party to proceed with the appropriation in lieu of the collateral taker. Finally, the number of perfection mechanisms for pledges over book-entry securities has been increased by sanctioning different change of control mechanisms set forth in the American Uniform Commercial Code as additional perfection alternatives.

ii Fiduciary Act 2003

The Fiduciary Act 2003 continues to offer interesting structuring opportunities. Pursuant to fiduciary agreements governed by the Fiduciary Act 2003, a fiduciary or creditor obtains ownership of the transferred assets. These assets are not part of its personal estate and may not be seized by its creditors in that they will form part of a segregated ‘fiduciary property’. The Fiduciary Act 2003 expressly states that fiduciary agreements may be used for security purposes. Fiduciary agreements are, in principle, available for all types of assets, including shares, marketable financial instruments, bank assets, equipment, raw materials and inventory, intellectual property rights, claims and receivables.

iii Double Luxco

The Double Luxco has been developed in connection with the French leveraged buyout (LBO) market to provide a response to the challenges of French insolvency laws. It is now used in LBO transactions across Europe.

Under French law, as well as in other European civil law jurisdictions, secured debt needs to be due and payable for lenders to enforce their security package. This often means that secured lenders will be required to accelerate the financing prior to enforcement. However, in this case, there is a significant risk that the borrower would apply for some form of insolvency proceeding and as result prevent the secured lenders from enforcing their security.

3 Mémorial A – No. 128 of 16 August 2005.
In this context, the aim of the Double Luxco is to shift the enforcement point towards the Luxembourg jurisdiction, which is considered to be creditor-friendly and does not require that secured debt be due and payable for lenders to enforce their security package.

In a Double Luxco, the acquisition vehicle (e.g., a French special purpose vehicle) is held by a Luxembourg vehicle (Luxco 1), itself held by another Luxembourg vehicle (Luxco 2). Each of the Luxcos will give a pledge over the shares, and any other debt or quasi-equity it owns in its subsidiary as security for the repayment of the borrower debt.

The key component of the structure is to create a security interest under Luxembourg law granted by Luxco 1 over the shares in Luxco 2 that, pursuant to Article 8 of Regulation (EU) No. 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (the European Insolvency Regulation), is located in Luxembourg and, therefore, remains subject to Luxembourg law. The risk that the borrower or the Luxembourg entities would file for, for example, safeguard proceedings in France on the basis that it had its centre of main interest (COMI) in France (a COMI shift), is thus mitigated. The European Insolvency Regulation, which is the recast of Council Regulation (EC) No. 1346/2000 of 29 May 2000 on insolvency proceedings, as amended, entered into force on 26 June 2016 and applies to insolvency proceedings from 26 June 2017. The key changes include, among others, a new definition of COMI (see Section VII.i) and the introduction of new rules to determine the location of assets (e.g., cash held in accounts with a credit institution is located in the Member State indicated in the account’s International Bank Account Number).

Some additional features have been built into the Double Luxco structure that allow the beneficiaries of a share pledge to vote on certain matters as if it were a shareholder without having to enforce the share pledge.

iv Alternative credit providers

According to the Luxembourg Act dated 5 April 1993 relating to the financial sector, as amended (the Banking Act 1993), any person granting loans on a professional basis must hold a licence of a credit institution or a professional in the financial sector carrying on lending activities in Luxembourg. In particular, Article 28-4 of the Banking Act 1993 defines professionals carrying on lending operations as professionals whose activity consists of granting loans to the public for their own account (without calling on public savings to refinance themselves). Article 28-4 not only covers the origination of loans (on a primary basis), but also the acquisition of undrawn or partially drawn loans (on a secondary basis) by a Luxembourg entity. Financial leasing and factoring activities also fall under Article 28-4.

Nonetheless, in certain instances lenders will be able to benefit from an exemption from licensing requirements under Article 28-4 of the Banking Act 1993. For instance, securitisation transactions are expressly excluded from its scope. There are also exemptions (by way of interpretation and administrative practice) that are granted by the CSSF (the CSSF Exemptions) insofar as loans are not granted to the public. The CSSF describes the notion

7 On 9 June 2016, the CSSF updated its FAQ concerning the Luxembourg Act dated 12 July 2013 on alternative investment fund managers, which includes FAQ 22 relating to alternative investment fund managers and alternative investment funds engaging in loan origination, or loan participation or acquisition. This FAQ is available at: www.cssf.lu/fileadmin/files/AIFM/FAQ_AIFMD.pdf.
of ‘public’ in a negative way and considers that a ‘limited circle of persons previously known to the lender’ does not fall within the notion of public. To assess the meaning of ‘restricted circle of persons previously known to the lender’, the CSSF applies two cumulatively criteria:

a) the number of persons concerned must be limited (though the CSSF does not set a cap for the number of people above which the restricted circle no longer exists); and

b) the persons concerned must be identified or identifiable in the sense of an existing relationship or a relationship that is in the process of being built on the basis of objective predetermined criteria (before the granting of the loans).

Furthermore, the requirement under Article 28-4 to hold a licence for carrying on lending activities only applies to the extent that loans are granted ‘on a professional basis’. In other words, the granting of loans must be a regular occupation or a business activity. The reference to the professional character of the lending activity implies that it is performed repetitively and that unique or one-off lending operations are subject to neither Article 28-4 nor the Banking Act 1993 in general. In the same vein, the acquisition of fully drawn loans would normally be exempted from licensing requirements, as this would not be regarded as the granting of a loan. Where partially drawn or undrawn loans are concerned, or where the transfer concerns loans that have been entered into simultaneously or immediately prior to the transfer of the loans, it is likely that Article 28-4 will kick in (unless one of the CSSF Exemptions is available).

III TAX CONSIDERATIONS

i Withholding tax

Interest payable under, or with respect to, Luxembourg law or foreign law loan agreements or security arrangement agreements may, in principle, be made free and clear of, and without withholding or deduction for or on account of, withholding tax in Luxembourg, provided that:

a) all payments and transfers made by, on behalf, in favour or for the account of, the Luxembourg company under such agreements, are made on an arm’s-length basis and are in accordance with market practice;

b) the Luxembourg company is not, is not deemed to be and, as a result of entering into and performing such agreements, will not be, over-indebted in light of the current practice of the Luxembourg tax administration; and

c) none of the parties to such agreements will have any relation with the Luxembourg company other than that of an independent third party acting in the normal course of its business or will maintain any particular economic relation with the Luxembourg company, other than that contemplated by such agreements.

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8 This remains subject to the application of Luxembourg law of 23 December 2005, as amended, introducing a withholding tax of 20 per cent on payments of interest or similar income made or ascribed by a paying agent established in Luxembourg to or for the benefit of an individual beneficial owner who is a resident of Luxembourg.
Registration duties

There are, in principle, no stamp, registration or similar taxes, duties or charges under the laws of Luxembourg payable in connection with the execution, performance, and enforcement by the relevant parties of Luxembourg law or foreign law loan agreements, or security arrangement agreements, except security interests that must be registered with public authorities in Luxembourg (such as mortgages over real estate property, aircraft or ships, general business pledges, pledges over IP rights), subject to the following.

The registration of any such agreements with the Administration de l’enregistrement, des domaines et de la TVA in Luxembourg will be required if any such agreements are physically attached to a public deed or to any other document subject to mandatory registration, in which case either a nominal registration duty or an ad valorem duty (e.g., 0.24 per cent of the amount of the payment obligation mentioned in the document so registered) will be payable depending on the nature of the document to be registered.

CREDIT SUPPORT AND SUBORDINATION

Security

Security interests governed by the Collateral Act 2005

The Collateral Act 2005 is regarded as one of the most creditor-friendly legal frameworks for security interests globally. It contemplates liberalised rules for creating and enforcing financial collateral arrangements and shields financial collateral arrangements from insolvency proceedings. The Collateral Act 2005 expressly provides that financial collateral arrangements (including pledges) are valid and enforceable, even if entered into during the pre-bankruptcy period (the ‘hardening’ or ‘suspect’ period), against all third parties including the insolvency receiver, liquidators and other similar persons irrespective of any insolvency, liquidation or other situation affecting anyone of the parties (except in the case of fraud).

The Collateral Act 2005 applies to any financial collateral arrangements, regardless of the status of the pledgor or the pledgee and of the nature of secured liabilities, and covers financial instruments in the widest sense as well as cash claims and receivables. Accordingly, pledges over shares, book-entry securities, intra-group loan receivables and pledges over bank accounts may benefit from this attractive framework.

The Collateral Act 2005 also provides for transfers of title by way of security and recognises the right of the pledgee to re-hypothecate the pledged assets. It enables the pledgee to use and dispose of the pledged assets. Contractual arrangements allowing for substitution and margin calls are expressly recognised by the Collateral Act 2005 and are protected in insolvency proceedings (in respect of which, security interests other than those covered by the Collateral Act 2005 and granted during the pre-bankruptcy suspect period can be challenged).

Creation and perfection requirements

The Collateral Act 2005 provides for a liberalised set of rules for creating and perfecting securities. As such, pledges over shares will be validly created and enforceable against third parties (depending on the type of company whose shares are pledged) by the execution of the pledge agreements or the registration of the pledge in the shareholders’ register of the company concerned in the case of registered shares; the effective transfer of the shares to the
pledgee (or a third party appointed by the pledgee) in the case of shares in bearer form; or by the registration of the pledge in the register of the depositary in the case of immobilised bearer shares. Other rules apply in the case of shares in book-entry form.

A pledge over intra-group loans or receivables governed by Luxembourg law or owed by a Luxembourg obligor is validly created and enforceable against third parties by the execution by the pledgor and the pledgee of the pledge agreement, and binding against the debtor upon the debtor having knowledge of the creation of the pledge. Future intra-group loans or receivables may be pledged, provided that they are determinable at the time the pledge is granted. Depending on the nature of receivables, the practice is to cover new receivables by establishing lists of receivables on a regular basis and servicing notices accordingly.

A pledge over bank accounts held with a credit institution in Luxembourg typically covers cash and book-entry securities. The pledged account can be either blocked or operated pursuant to the parties’ agreement. The pledge will be notified to the depositary bank or, as applicable, consent will be obtained from the depositary bank as to:

a acceptance of the pledge by the depositary bank; and

b waiver and exclusion of bank set-offs and general pledge (available under general business conditions of Luxembourg banks).

Enforcement measures

Under the Collateral Act 2005, pledgees can benefit from enforcement measures that are generally viewed as creditor-friendly. A pledgee may enforce a pledge, without the obligation of prior notice to the pledgor, in its absolute discretion and in the most favourable manner provided by it.

In the case of a pledge over shares, the pledge may generally be enforced by the pledgee by way of:

a out-of-court appropriation of the shares at a price determined pursuant to a valuation method agreed upon by the parties in the pledge agreement (i.e., typically, a valuation to be carried out by an independent auditor or an investment bank chosen by the pledgee at the time of enforcement); or

b out-of-court private sale on arm’s-length commercial terms (i.e., the sale must be made at a price that a well-informed independent willing buyer would normally, under relevant market conditions and taking into account the information available at that time, be prepared to pay to a willing seller).

The pledge agreement will typically provide for the possibility to enforce the pledge agreement by way of appropriation before the valuation has been commenced or completed, which may allow for the pledge to be enforced by the pledgee overnight. However, the pledgee may decide, depending on the particular circumstances and to reduce the risk of post-enforcement liability proceedings, to wait for the valuation to be completed before enforcing the pledge.

Under the Collateral Act 2005, the parties are free to determine the trigger event for enforcing a security interest. This can be an event of default of a non-payment type or any other event agreed upon by the parties, the occurrence of which will entitle the pledgee to

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9 For further information on this topic, refer to ‘Enforcing financial collateral arrangements in the new world – challenging times’, Henri Wagner and François Guillaume de Liedekerke, Bulletin Droit et Banque, No. 47, April 2011.
enforce the security. However, an enforcement of a pledge triggered by an event of default other than a payment default may raise practical difficulties that will need to be carefully assessed on a case-by-case basis.

Comparable attractive enforcement methods exist for pledges over accounts or receivables. Furthermore, a pledge over an account and a pledge over receivables may generally be enforced by the pledgee by requesting payment to it by the bank where the account is held of the pledged assets or by the debtor of the pledged receivables, in and towards full payment and discharge of the secured liabilities.

Enforcement measures under the Collateral Act 2005 may undoubtedly be considered highly attractive to lenders. Therefore, and to the extent possible, market practice in Luxembourg consists of bringing a security package within the scope of the Collateral Act 2005.10

Other security interests

Luxembourg also has a trial-tested and relatively creditor-friendly security interest regime outside the Collateral Act 2005, and security interest can normally be taken over a wide range of assets.

Mortgages over real estate property, aircraft or ships located in Luxembourg

A mortgage may be taken over real estate property or aircraft and must be drafted in the form of a notarial deed. A mortgage over ships may be constituted by a private written agreement or a notarial deed. The mortgage agreement or deed must specify the assets covered precisely and must be registered at the mortgage registry of the judicial district in which the real estate property is located, in the maritime registry or in the registry for aircraft mortgages, as the case may be, to be valid and enforceable against third parties. Registration is subject to ad valorem taxes and translation requirements, and is valid for 10 years (renewable). The mortgage may be granted only to secure a sum of money that is certain and determined. The mortgage does not cover rentals and insurance policy proceeds, which must be separately pledged.

Pledges in respect of proceeds from insurance policies

A pledge can be granted in respect of proceeds from insurance policies. The pledge will be subject to similar rules as for a pledge over receivables.

Pledges over intellectual property rights

A pledge can be granted over patents. Pledges over copyrights (and, to a certain extent, over trademarks and models or designs) are subject to debate and require a case-by-case

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10 A number of closely watched court decisions have recently strengthened the legal security and attractiveness of financial collateral arrangements subject to the Collateral Act 2005. For example, the decision of the Court of Appeal sitting in summary proceedings, No. 35824, 3 November 2010, which confirmed that the enforcement of a pledge agreement made in accordance with the terms of the pledge agreement may in principle not be challenged and that only action for liability may potentially be taken against the pledgee. Luxembourg courts have also limited the possibility to appoint a receiver or administrator in the context of enforcement procedures of financial collateral arrangement as long as enforcement measures comply prima facie with the conditions provided for in the pledge agreement (Court of Appeal sitting in summary proceedings, No. 346743, 3 June 2009, and Luxembourg District Court sitting in summary proceedings, 11 February 2010).
analysis. For validity and enforceability between the parties and against third parties, pledge agreements relating to patents, trademarks and models or design must be registered with the appropriate national or international intellectual property registration authorities.

General business pledges

A general business pledge is available under Luxembourg law and covers the following:

- clientele;
- business name and goodwill;
- licences;
- trademarks and patents;
- leases;
- furniture;
- materials;
- rolling stock and other tools; and
- 50 per cent of the value of the inventory.

Receivables, securities and cash must be expressly included to be covered by the pledge (although there are no Luxembourg court precedents to confirm the validity of such inclusion). The general business pledge is only available over industrial or commercial business conducted in Luxembourg and can only be granted to credit institutions (and, for historic reasons, breweries) authorised specifically by the Luxembourg government to that end.

For validity and enforceability against creditors, the pledge must be registered at the mortgage registry of the judicial district in which the business is located. Registration is subject to ad valorem taxes and translation requirements, and is valid for 10 years (renewable).

Satellites, rights to orbital slots and customer contracts

For assets such as satellites, rights to orbital slots or customer contracts, it may be difficult to obtain a valid Luxembourg law security interest and it would accordingly be preferable to restrict transfers of such assets to companies in Luxembourg.

Under Luxembourg law, contracts providing for reciprocal obligations of the parties may not be pledged as such. A pledge may, however, be granted over the monetary or restitution claims resulting from the contracts. An analysis of the customer contracts, as well as of the contractual documentation relating to satellites and rights to orbital slots, may be needed to determine whether Luxembourg security interests over those assets would be appropriate.

A possible alternative could be to subject those assets (according to the lex rei sitae rule) to foreign law security interests, provided that those laws allow for such security interests and that the assets, though owned by the Luxembourg companies, are not located (or deemed to be located) in Luxembourg.

Guarantees and other forms of credit support

Besides security interest rights, Luxembourg law also provides for security in the form of personal guarantees such as a suretyship, an independent or demand guarantee, or a letter of comfort.
Suretyship

A suretyship is an agreement made between the surety and the debtor whereby the surety undertakes to pay the debtor’s debt if the debtor is unable to make the payment. It is subject to the validity of the underlying obligation (e.g., a facility) and to all the defences that apply to the underlying obligation, which means that the surety may use all exceptions available to the debtor against the beneficiary of the suretyship.

If the suretyship is granted by a natural person, pursuant to Article 2016 of the Luxembourg Civil Code:

a if a creditor who benefits from the suretyship does not inform the natural person at least once a year about the evolution of the guaranteed claim and its accessories, the creditor will no longer be entitled to the claim’s accessories (including interest), costs and penalties; and

b a professional creditor is not entitled to rely on a suretyship agreement entered into by a natural person whose commitment was, at the time of the entry into the suretyship agreement, obviously disproportionate to this person’s assets and income, unless at the time the surety is called, this person's estate enables him or her to comply with the related payment obligation.

Although there is, to the authors’ knowledge, no Luxembourg (published) case law on this point, it cannot be excluded that a Luxembourg court would hold Article 2016 of the Luxembourg Civil Code to be a point of international public policy that would set aside the relevant foreign governing law.

A suretyship is generally considered to provide for some level of comfort to a creditor under Luxembourg law depending on the particularities of the transaction, although lenders usually require more robust types of guarantees.

Independent or demand guarantee

An independent or demand guarantee is a commitment of an autonomous nature, which shall expressly set out that:

a it is a demand guarantee and not a suretyship (although despite the expressed common intention of the parties to this effect, the guarantee could be construed by the relevant competent court as a suretyship);

b the obligations of the guarantor constitute an autonomous guarantee that is not an accessory to the principal underlying obligation (e.g., a facility); and

c the guarantor agrees that any invalidity relating to the underlying obligation would not cause the demand guarantee to be null and void.

While being in a stronger position than in the suretyship, the beneficiary of the demand guarantee will not be protected in the case of bankruptcy of the guarantor, and its claim will rank pari passu with the other creditor of the guarantor.

Letter of comfort

A letter of comfort is a document generally issued by a bank or a parent company that provides for an assurance as to the debt of the debtor. The legal force of the letter will depend on the exact terms therein. It should therefore be drafted in a way that the issuer undertakes.
an obligation of results. However, in the case of default, even with a firm letter of comfort, the issuer could not be forced to perform the debtor’s obligation but only to indemnify the creditor for any (proven) damage.

iii Priorities and subordination

The validity of certain clauses and provisions pertaining to subordination and priorities is not entirely settled under Luxembourg law, and the possibility that such clauses would be voided on public policy grounds cannot be entirely excluded.

There are no general Luxembourg law provisions or regulations on contractual subordination (other than under Luxembourg banking, insurance and securitisation legislation), no Luxembourg well-established (published) case law, and only little legal literature on the validity and enforceability (under Luxembourg law) of contractual subordination. Contractual subordination would be upheld by Luxembourg courts, even in the event of insolvency proceedings affecting the Luxembourg party concerned (although there is uncertainty as to whether an insolvency receiver of a Luxembourg party debtor would accept the hierarchy between senior and subordinated creditors of this Luxembourg party). To assess contractual subordination in general, Luxembourg courts would mainly turn to Belgian case law and legal literature, which seem to admit the validity and enforceability of a provision whereby a party agrees to subordinate its claim to the claim of another (senior) creditor.

It is also generally held that a junior creditor may agree to subordinate his or her claim, whether or not secured, to that of a senior creditor by agreeing to turn over (transfer) proceeds of the junior claim and its security to the extent necessary to pay the senior claim. Notice to the common debtor is not necessary for the validity of the turnover against creditors of the junior creditor. However, from a Luxembourg law perspective, turnover provisions might be regarded as a mere contractual mechanism and would not give the senior creditor a proprietary claim on the insolvency of the junior creditor. If a junior creditor has been paid before a senior creditor and bankruptcy proceedings are instituted against the junior creditor before the amounts so paid to the junior creditor have been paid and distributed to the senior creditor, it is uncertain whether the senior creditor would be able to claw back these amounts from the junior creditor. There is uncertainty whether a Luxembourg insolvency receiver of a debtor subject to Luxembourg insolvency proceedings would, where applicable, accept the hierarchy between senior and subordinated creditors of this debtor.

Luxembourg law neither contains a specific legal provision that expressly recognises limited recourse provisions nor is there any Luxembourg (published) case law or well established legal literature dealing with such clauses. Nonetheless, Belgian case law (to which Luxembourg courts often turn in these instances) seems to admit the validity and enforceability of a provision whereby contractual arrangements are established in conformity with contact law to the extent that they do not grant to a particular creditor a better rank in the distribution of the debtor’s assets. The principle of pari passu treatment of creditors (according to which contractual arrangements, entered into prior to the opening of insolvency proceedings and designed to unfairly benefit one creditor to the detriment of other creditors by giving it a preferential right not provided for by law, are unlawful) aims only at protecting the rights of all the creditors, and as such is public policy. In other words, the debtor may not, by an arrangement with one of its creditors, impair the rights of the other creditors. Nothing, however, prohibits one or more creditors to limit, derogate from, or even renounce their rights in the sense that they dispose of their own rights without altering other creditors’ rights.
Non-petition clauses (a clause whereby one or more parties waive *ab initio* their right to institute bankruptcy proceedings against their debtor) are likely to not be recognised under Luxembourg law. Although there is no specific Luxembourg case law or legal literature, Belgian case law does not recognise the enforceability of a non-petition clause because it violates public policy.

V LEGAL RESERVATIONS AND OPINIONS PRACTICE

Luxembourg law generally upholds the principle of legal and contractual certainty, and legal reservations may be less intrusive than other continental European jurisdictions. Nonetheless, its civil law heritage means that lenders will have to take into account certain public policy considerations.

i Financial assistance and corporate benefit

Assuming the grantor of a guarantee is a private limited liability company or a public limited liability company (which is typically the case for Luxembourg holding companies), some guidance as to the granting of guarantees and guarantee limitation is necessary. However, guarantee limitations would normally not apply where the security grantor grants financial collateral governed by the Collateral Act 2005 or other security interests.

A company may give a guarantee provided the giving of the guarantee is covered by the company's corporate objects and in the corporate interest of the company. In other words, a group guarantee must comply with the principle of speciality (the Corporate Objects Test) and company law (the Corporate Benefit Test).

As regards the Corporate Objects Test, the giving of a guarantee does not necessarily fall within the scope of a company's corporate objects. This point must be analysed on a case-by-case basis in light of the guarantor's corporate objects clause in its articles of association.

As regards the Corporate Benefit Test, the managers or directors of a company must act in the best interest and for the corporate benefit of the company. The giving of a guarantee in support of a third party's indebtedness is not necessarily ultra vires if the transaction furthers, even indirectly, the corporate purpose of each guarantor. The test is whether the company that provides the guarantee receives some consideration in return (such as an economic or commercial benefit) and whether the benefit is proportionate to the burden of the assistance. Accordingly, a guarantee that could adversely affect the creditors of the company is not necessarily, per se, against the company's best interest. However, a guarantee that substantially exceeds a guarantor company's ability to meet its obligations to the beneficiary of the guarantee and to its other creditors would expose its directors to personal liability. It is, therefore, prudent (for upstream or cross-stream guarantees) to limit the guarantee to a percentage (normally between 80 per cent and 100 per cent) of the company's net worth (or similar reference value) so that, at least in accounting terms, the guarantee does not adversely affect the creditors of any of the guarantors.

It follows that a Luxembourg company may, in principle, provide a guarantee for the benefit of other group companies if it can be demonstrated that:

a the company belongs to a group of companies that has a real structure and is organised in the view of a common economic, industrial and commercial policy;

b the company derives a benefit from giving the guarantee; and

c the guarantee amount is not disproportionate to the company’s financial means.
For an upstream or cross-stream guarantee, the insertion of limitation language will generally be required by the company acting as a guarantor. The same limitations do not apply for downstream guarantees.

If the assistance is deemed contrary to the interest of the company by the courts, its directors may be held liable for action taken in that context. Further, under certain circumstances, the directors of the Luxembourg company might incur criminal penalties based on the concept of misappropriation of corporate assets (Article 1500-11 of the Luxembourg Act dated 10 August 1915 on commercial companies, as amended (the Companies Act 1915)). Article 1500-11 of the Companies Act 1915 makes it a criminal offence for the directors and managers of a Luxembourg company, whether having been officially appointed or being de facto directors or managers (which might include legal persons), if, acting in bad faith, they have made use of corporate assets or of corporate credit for uses other than those required by the interests of such company, and for their own personal benefit or for the benefit of companies or enterprises in which they have a direct or indirect interest. It cannot be excluded that, if the relevant transaction were to be considered as a misappropriation of corporate assets by a Luxembourg court, or if it could be evidenced that the other parties to the transaction were aware of the transaction not being for the corporate benefit of the Luxembourg company, the transaction might be declared void or ineffective based on the concept of illegal cause. Also, depending on the factual circumstances, a liquidator, an insolvency receiver or creditors of the assisting company could seek the liability of the banks (e.g., where the guarantee trigger has caused the insolvency of the assisting company or has caused a wider consequential loss to the creditors of such company).

In the case of a public limited liability company, parties will have to take into consideration specific financial assistance rules. According to Article 430-19 of the Companies Act 1915, a public limited liability company is prohibited from granting loans, guarantees or advancing funds to a third party for the acquisition of its own shares unless a ‘whitewash’ type of procedure is followed.

ii Insolvency proceedings and hardening period rules

Insolvency situations are governed by a set of rules that have been elaborated by courts and legal literature around the cardinal principle of pari passu ranking of creditors. Under applicable Luxembourg law, it is possible for a company to be insolvent without necessarily being bankrupt. If a company fails to meet the two cumulative tests of bankruptcy – namely the cessation of payments and the loss of creditworthiness – it is not deemed bankrupt. The judgment declaring the bankruptcy, or a subsequent judgment issued by the court, usually specifies a period not exceeding six months before the day of the judgment declaring the bankruptcy. During this period (the suspect period), the debtor is deemed to have been already unable to pay its debts generally or obtain further credit from its creditors or third parties. Payments made, as well as other transactions concluded or performed, during the suspect period, and specific payments and transactions during the 10 days before the commencement of that period, are subject to cancellation by the Luxembourg court upon proceedings instituted by the Luxembourg insolvency or bankruptcy receiver.

iii Enforcement of foreign judgments

A final and conclusive judgment in respect of agreements obtained against a Luxembourg company in an EU Member State court would be recognised and enforced by Luxembourg courts without re-examination of the merits of the case subject to and in accordance with
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).\textsuperscript{11} This is provided that the judgment in question qualifies as a judgment (as defined therein) or, as the case may be, is subject to and in accordance with Council Regulation 805/2004 of 21 April 2004 creating a European enforcement order for uncontested claims, provided that the judgment in question has been certified as a European Enforcement Order (as referred to therein).\textsuperscript{12}

A final and conclusive judgment in respect of agreements obtained against a Luxembourg company in an Icelandic, Swiss or Norwegian court would be recognised and enforced by Luxembourg courts without re-examination of the merits of the case subject to the applicable enforcement procedure and conditions of the Convention on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters signed at Lugano on 30 October 2007.

A final and conclusive judgment in respect of agreements obtained against a Luxembourg company in another foreign court than the courts referred to above would be recognised and enforced by Luxembourg courts subject to the applicable enforcement procedure (as set out in the relevant provisions of the Luxembourg New Civil Procedure Code). Pursuant to present Luxembourg case law, the enforcement of such judgment is subject to the following requirements:

\begin{itemize}
\item[a] the foreign judgment must be enforceable in the country of origin;
\item[b] the court of origin must have had jurisdiction both according to its own laws and to the Luxembourg conflict of jurisdictions rules;
\item[c] the foreign proceedings must have been regular in light of the laws of the country of origin;
\item[d] the rights of defence must not have been violated;
\item[e] the foreign court must have applied the law that is designated by the Luxembourg conflict of laws rules or, at least, the judgment must not contravene the principles underlying these rules;
\item[f] the considerations of the foreign judgment as well as the judgment as such must not contravene Luxembourg international public policy; and
\item[g] the foreign judgment must not have been rendered as a result of or in connection with an evasion of Luxembourg law.
\end{itemize}

\textbf{iv Legal opinion practice}

The nature of legal opinion practice in Luxembourg is characterised by a certain level of flexibility, and a legal opinion may be given by either creditor counsel or debtor counsel as the case may be. Legal opinions are typically addressed to the finance parties, but disclosure to certain advisers such as auditors or regulators is generally accepted. In the case of primary syndication, it is market practice to allow any lender joining the syndication within three months of the opinion being issued to rely on the legal opinion.

\textsuperscript{11} [2012] OJ L 351/1.
\textsuperscript{12} [2004] OJ L 143/15.
VI LOAN TRADING

Most of the loan trading transactions in Luxembourg are carried out by inbound financial and credit institutions, and these transactions are normally governed by the law with which the institutions are most familiar (i.e., English or New York law). So far as the loan transfer and its effects are governed by English law, the choice of law is recognised in Luxembourg pursuant to Regulation (EC) No. 593/2008 of the European Parliament and the Council of 17 June 2008 on the law applicable to contractual obligations, except in limited circumstances. The choice of New York law would equally be recognised, except in limited circumstances.

However, to the extent that it relates to Luxembourg assets, in most cases the security package will be governed by Luxembourg law, and market participants regularly seek advice on ensuring that secondary market purchasers obtain the benefit of Luxembourg security or guarantees (if any) after a loan transfer (the transfer).

If the security arrangement is a pledge or a suretyship, it will be transferred automatically together with the underlying main obligation (the pledge and the suretyship each being an accessory to the main obligations (Article 1692 of the Luxembourg Civil Code)). If the transfer is effected through a novation, the pledge or suretyship in question would lapse unless expressly reserved or confirmed, respectively, by the parties concerned.

If the security arrangement is a transfer of title by way of security (which is not an accessory to the underlying main obligation), the new transferee would require an express confirmation of the transfer from the transferor (as security provider). The same applies to autonomous independent personal guarantees.

In addition, Luxembourg market practice typically recommends ‘re-perfecting’ the Luxembourg law-governed security arrangement following the transfer. For pledges over registered securities, the re-perfection is achieved by a new registration of the pledge in the securities register. For pledges over bank accounts (cash or securities), the re-perfection is achieved by notice to the Luxembourg account bank relating to the identity of the new pledgee; and for pledges over receivables, the ‘re-perfection’ is usually achieved by notice to the debtor of the pledged receivables relating to the identity of the new pledgee. In all those instances, the relevant pledgor should arrange for the re-perfection or notification to be implemented. Timing will depend on the cooperation of the counterparty, where necessary. So far as personal autonomous guarantees and transfers of title by way of security are concerned, the guarantor or the new transferor’s (as security provider) consent would have to be obtained.

Additional steps would be required in the case of general business pledges, mortgages and pledges over intellectual property rights, patents, trademarks and copyrights.

If loan trading transactions are carried out through alternative funds (such as alternative debt funds) the following would occur:


b the obligations arising for the parties to such agreements would be subject to the AIFMD.

14 Mémorial A – No. 119 of 15 July 2013.
VII OTHER ISSUES

i Insolvency proceedings and COMI

The European Insolvency Regulation, which establishes common rules on cross-border insolvency proceedings, applies in Luxembourg. In broad terms, the European Insolvency Regulation provides that main insolvency proceedings are to be opened in the Member State where the debtor has his or her COMI. The European Insolvency Regulation defines COMI as ‘the place where the debtor conducts the administration of its interest on a regular basis and which is ascertainable by third parties’ and establishes a rebuttable presumption that in the case of a company or legal person the COMI is at the company’s registered office. This presumption will not apply if the registered office has been moved to another Member State within the three months prior to the request for opening insolvency proceedings.

These proceedings will have universal scope and encompass a debtor’s assets throughout the European Union (subject to secondary proceedings opened in one or more EU Member States, although such proceedings will be limited to the assets in that state and will run in parallel to the main proceedings). Creditors will have the comfort that where a company has a branch or significant assets or activities in more than one EU Member State, the proceedings opened in one Member State will encompass assets located throughout the European Union and even those assets moved by the debtor to another Member State after the date of filing.

Main insolvency proceeding may be opened in Luxembourg if a company’s COMI is located in Luxembourg and the conditions provided for under Luxembourg law for the opening for an insolvency proceeding are met. As regards bankruptcy proceedings, a Luxembourg company is bankrupt when:

- it has a commercial object or a commercial form;
- it has ceased its payments and is unable to meet its commitments; and
- its credit is exhausted.

In accordance with the principle of universality of insolvency proceedings, the assets owned directly by the bankrupt company or by one of its branches, located both in Luxembourg and in other jurisdictions, as a matter of Luxembourg law, form part of the insolvent estate. The powers of the receivers, appointed in connection with the bankruptcy of a company by a Luxembourg court, may be exercised over the assets located outside Luxembourg, subject to recognition abroad. For instance, this would include escrow monies held abroad to the extent they are still deemed, in accordance with local law, to belong to the insolvency estate.

Under the European Insolvency Regulation, the conditions under which set-off is available are normally governed by the law of the Member State in which insolvency proceedings are opened. If the insolvency proceedings are commenced in Luxembourg, and Luxembourg law allows for insolvency set-off, it will in principle be effective. In this respect, set-off and close-out netting are generally recognised and enforceable under the Collateral Act 2005.
ii  Compounding of interest
The right to compound interest is not entirely accepted under Luxembourg law, and the
validity of such clauses is limited, pursuant to Article 1154 of the Luxembourg Civil Code,
to cases where:
   a  the interest has been due for at least one year; and
   b  the parties have specifically provided in an agreement (to be made after that interest
       has become due for at least one year) that the interest may be compounded (or in
       the absence of such agreement, the creditor may file an appropriate request with the
       relevant court).

The provisions of Article 1154 of the Luxembourg Civil Code are generally considered to be
a point of public policy under Luxembourg law, and would, therefore, apply to agreements
governed by Luxembourg. For agreements that are not governed by Luxembourg law, it is
possible, although unlikely, that a Luxembourg court would hold these provisions to be a
point of international public policy that would set aside the relevant foreign governing law.

iii  Powers of attorney and service of process agent
Unless otherwise provided for or unless the contrary results from the factual circumstances, a
power of attorney or agency, whether irrevocable, will terminate by force of law, and without
notice, upon the occurrence of insolvency events affecting the principal or the agent. A power
of attorney or agency might become ineffective upon the principal entering into controlled
management or reprieve from payment. The designation of a service of process agent may
constitute (or may be deemed to constitute) a power of attorney or agency.

There are uncertainties under Luxembourg law as to the effectiveness or ineffectiveness
of a purported revocation, and the consequences of such revocation by the principal of a
power of attorney or agency expressed to be irrevocable.

iv  Foreign law security interests and floating charges
Contractual security arrangements that are not expressly recognised under Luxembourg law,
such as the assignment for security purposes of rights or assets other than those expressly
covered by the Collateral Act 2005, might not be recognised or enforced by Luxembourg
courts, in particular where the Luxembourg security grantor becomes subject to Luxembourg
insolvency proceedings (without prejudice to the creditor protective provisions of the European
Insolvency Regulation) or where the Luxembourg courts otherwise have jurisdiction because
of the actual or deemed location of the relevant rights or assets.

A floating charge over assets located in Luxembourg would in principle not be
recognised by a Luxembourg court.

v  Concurrent proceedings
The provisions of a jurisdiction clause whereby the taking of proceedings in one or more
jurisdictions shall not preclude the taking of proceedings in any other jurisdiction, whether
concurrently or not, might not be entirely enforceable in a Luxembourg court. If proceedings
were previously commenced between the same parties and on the same grounds as the
proceedings in Luxembourg, a plea of pendency might be opposed in the Luxembourg
court and proceedings either stayed pending the termination of the proceedings abroad or
dismissed, as the case may be.
vi Recognition of trust

Luxembourg law recognises trusts referred, and subject, to the reservations expressed in the Convention on the law applicable to trusts, and on their recognition achieved at The Hague on 1 July 1985. If the trust relates to, or applies in respect of, assets located in Luxembourg, the situation of the trustee will be determined by reference to the situation of the legal owner of such assets without prejudice to the principle of segregation of the trust’s assets and the trustee’s personal estate. This does not mean that trusts created abroad will necessarily be recognised by Luxembourg courts as to all their effects under their governing law. Under the Collateral Act 2005, a financial collateral arrangement may be created in favour of a person acting on behalf of the beneficiaries of the financial collateral arrangement, of a fiduciary or of a trustee, provided that the beneficiaries of the financial collateral arrangement, present or future, are identified or ascertainable.

vii Ranking of security interests

There are rights of preference (e.g., tax payments, social security charges and wages) existing by operation of law and ranking prior to the ranking of security rights.

viii True sale

Under Article 1689 of the Luxembourg Civil Code, an assignment agreement is validly created between the assignor and the assignee by their mutual consent. This mutual consent operates a ‘true sale’ of the receivable among the seller and the assignee as a matter of Luxembourg law. However, the assignment will only be enforceable as regards the debtor and third parties (including creditors of the seller and its insolvency administrator) upon notification of the assignment to the debtor or acceptance thereof by the debtor.

ix EMIR Regulations

Certain transactions, such as transactions involving certain types of derivatives, may be subject to Regulation (EU) No. 648/2012 of the European Parliament and of the Council of 4 July 2012 on over-the-counter derivatives, central counterparties and trade repositories15 or any delegated or implementing regulations (together the EMIR Regulations) and, as a result, the obligations arising for the parties under such agreements would be subject to the EMIR Regulations.

VIII OUTLOOK AND CONCLUSIONS

The financial markets turmoil of 2008 created a wave of consolidation in the banking sector and substantially reshaped the financial landscape in Luxembourg.

The enforcement of financial collateral arrangements, in the wake of the economic and financial markets turmoil of 2008, raised a number of issues that led to closely watched proceedings before Luxembourg courts. The general success of lenders in defending actions against enforcement has strengthened the legal security and attractiveness of financial collateral arrangements governed by Luxembourg law. Moreover, the Luxembourg legislator

Luxembourg

has recently further strengthened the appeal of the Collateral Act 2005 by confirming that the insolvency safe harbour provisions also apply to foreign law-governed collateral arrangements, which are similar to the Luxembourg collateral arrangement.

Regulatory changes have also had a significant impact on many market participants. The multitude of European and international legislative initiatives that were aimed at closing gaps in regulation and supervision that might adversely affect the stability of the international financial system, have also created increasing capital and reporting requirements.

In an uncertain regulatory environment, Luxembourg authorities have clearly aimed to differentiate themselves from their foreign counterparts by quality of service, responsiveness and approachability. In particular, the CSSF has in the past shown a desire to strike the right balance between increased supervision and the need for the financial sector to breathe and develop. While there is undoubtedly an international trend towards a common supervisory culture and a harmonised application of a single rule book, the CSSF seems committed to continue to advocate for a consensus-based model of supervision.

Luxembourg authorities have also taken considerable steps to promote Luxembourg as the premier international renminbi hub in the euro area and to solidify its position as one of the leading Islamic finance centres in Europe. As a result of these efforts, Luxembourg is now the leading European financial centre in terms of renminbi loans and deposits.

The Luxembourg government proposes to introduce a private foundation, as well as a structure of trust similar to the English law trust, into the Luxembourg legal framework, with a view to strengthen, among others, the Luxembourg wealth management and financial sectors. It is also currently being contemplated to overhaul the current Luxembourg insolvency regime and to put into place mechanisms that would help companies that are in difficulty to avoid bankruptcy proceedings.
I OVERVIEW

The Dutch loan finance market for corporate borrowers is still mainly handled out of banks. It can roughly be divided into three market segments. The small market segment represents principal loan amounts of up to approximately €30 million, which are often lent by a bank in a relationship context and on a bilateral basis. These loans are often documented on the basis of the bank’s own templates. When trading may be an option at a later stage, Loan Market Association (LMA) standards may also be used. Mid-market deals range from approximately €30 million up to approximately €250 million, and are often provided by a club of (mainly Dutch) banks on the basis of the LMA standards for investment grade or leveraged acquisition loans. For loans in excess of €250 million, larger syndicates often need to be formed. Given the limited number of sizeable Dutch banks active in the corporate lending market, non-Dutch banks are often required to be involved. Similarly, borrowers with foreign business or subsidiaries often try to engage banks from those jurisdictions as well.

Non-bank financing is also increasingly used but to a lesser extent, though the increasingly strict capital and risk management requirements applicable to banks lead to alternative credit providers increasing their share in the market (see Section VII). Such non-bank financing particularly includes equity financing, debt capital markets financing, private placements, securitisations, and financing by mezzanine and private debt funds.

II LEGAL AND REGULATORY DEVELOPMENTS

Dutch legal and regulatory developments from 1 June 2018 (other than through EU regulations) that are relevant for loan finance practice include the following:

a In July and August 2018, the Ministry of Justice and Security held a consultation on a draft bill, which prohibits restrictions on transferability and pledgeability of receivables that have arisen from the conduct of a profession or business and are transferred or pledged for financing purposes. By extending the asset base that can be transferred or pledged to financiers, the draft bill aims to increase the credit potential of (mainly) small and medium-sized enterprises and to create a level playing field with neighbouring jurisdictions. The Minister must now decide on the next steps.

b On 24 April 2019, the Dutch Authority for the Financial Markets and the Dutch Central Bank sent and published a letter to the CEOs of large financial institutions in the Netherlands on the ongoing reform of interest rate benchmarks and particularly

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the envisaged transition from critical interest rate benchmarks to alternative risk-free rates (RFRs). The letter urges market participants to transition to suitable replacement benchmark rates when available, to timely prepare for the transition, to analyse and address the risks involved, and to contribute to the development of alternative RFRs. Also, the CEOs are requested to answer certain questions assessing the progress of preparations being made for the transition.

After publishing an explanatory study of options on a review of the Dutch Financial Markets Supervision Act in 2016, holding a consultation thereon in early 2017 and assessing the analysis and responses received, the Minister of Finance informed Parliament in May 2019 that, mainly in view of the considerable time and costs involved, he does not consider it opportune to commence a full review of the Act at this moment. On the basis of the identified problems, he plans to make improvements to the Act on a more incidental basis.

III TAX CONSIDERATIONS

i Withholding taxes
A lender to a borrower, resident in the Netherlands, is not subject to any withholding tax with respect to payments due by the borrower under the loan, except if the loan qualifies as a participating loan, in which case payments to the lender are treated similarly to dividend payments and are subject to a 15 per cent dividend withholding tax. A loan is qualified as a participating loan if it has no maturity or a maturity over 50 years, is subordinated to all senior debt and is profit participating.

The government has, however, announced that the Netherlands will introduce a new withholding tax on interest paid (1) to group entities resident in low-tax jurisdictions or jurisdictions that are included in the EU list of non-cooperative jurisdictions, and (2) in abusive situations. This withholding tax on interest is intended to be effective from 2021 and a proposal of law to that effect is intended to be submitted to Parliament in the course of 2019.

ii Stamp taxes and duties
No stamp taxes or duties are due in connection with the issuance of debt by a Dutch borrower.

iii Corporate taxation for the borrower
A borrower who is subject to Dutch corporate income tax generally can deduct on an accrual's basis any compensation that is due to the lender, insofar as the compensation meets the arm's-length criterion. Various detailed anti-abuse provisions may apply that could restrict or eliminate entirely the deduction of interest. Certain rules only apply to related party debt, others also apply to third-party loans.

In addition, as of 1 January 2019, a generic limitation applies, annually restricting the net amount of deductible interest to 30 per cent of the borrower’s earnings before interest, tax, depreciation and amortisation.

iv FATCA
The Netherlands has entered into an agreement with the United States regarding the implementation of the Foreign Account Tax Compliance Act (FATCA) rules. Loan
documentation related to the issuance by Dutch borrowers generally includes standard provisions regarding FATCA rules that are in line with documentation included in similar documentation for issuers in other jurisdictions that have entered into such an agreement.

IV CREDIT SUPPORT AND SUBORDINATION

i Security

Asset classes over which Dutch law security can be granted

Under Dutch law, security can be taken over real property, receivables (including trade receivables, intercompany loans, cash deposited in bank accounts and insurance receivables), inventory, intellectual property and certain other asset classes, such as shares in Dutch companies. Whether security can be taken over other asset classes will depend on the types of assets involved. A Dutch law security right can only be vested in assets that are transferable (or assignable). Transferability (or assignability), and thereby pledgeability, of a receivable can be restricted by agreement between the relevant creditor and debtor. A draft bill is being considered that would prohibit these restrictions for certain types of receivables (see Section II).

Types of Dutch law security rights

Dutch law provides for two types of security rights:

a security created on registered assets, such as real property, ‘registered’ vessels and aircraft, and on limited rights vested therein (a mortgage); and

b security created on all other assets, whether tangible (such as movable assets) or intangible (such as receivables and registered shares) (a pledge).

The creation of Dutch law security

Security over the assets classes referred to above will be created as follows.

Dutch real property and other registered assets are mortgaged pursuant to a Dutch notarial deed and registration of the deed with the appropriate Dutch public register.

Trade receivables are pledged pursuant to a private deed and registration of the deed with the Dutch tax authorities (or pursuant to a notarial deed), without notification to the debtors of the receivables (an undisclosed pledge). An undisclosed pledge over receivables constitutes a valid right of pledge (but can be invoked against the debtor of the receivable only after it has been notified to it). The pledge will attach only to receivables that exist at the date of the deed or that will be directly obtained from an agreement or other legal relationship existing at that date. To nonetheless maximise the security coverage, the practical solution is that in the deed of pledge the pledgor will agree to periodically (usually between one and three months, depending on the speed at which the trade receivables portfolio is renewed) enter into an additional deed of pledge. Pursuant to that additional deed, the pledgor will pledge the receivables existing at the date of the additional deed or that will be directly obtained from a legal relationship existing at that date. Each additional deed of pledge must also be registered with the Dutch tax authorities. The original deed of pledge will set out the procedures to be followed (and grant any required powers of attorney) in connection with the signing and registration of each additional deed of pledge.

Dutch banks have implemented systems to further maximise their security coverage in relation to such trade or other receivables. Most Dutch banks pledge to themselves on a daily
basis the receivables required to be pledged to them by way of a standardised deed covering all pledgors that have granted them a power of attorney to do so (as most will have done). The general validity of this system has been confirmed by case law from the Dutch Supreme Court.

Receivables can also be pledged pursuant to a private deed (or notarial deed) and notification of that deed to the debtors of the receivables (a disclosed pledge). In practice, this type of creation of a pledge is reserved for specific types of receivables, including intercompany loans and insurance receivables. For legal reasons, cash deposited in bank accounts can be pledged only by way of a disclosed pledge. Generally, the pledgor shall not accept a disclosed pledge in respect of other receivables such as trade receivables, to both avoid the hassle of notifying large numbers of trade debtors of the pledge and avoid trade debtors being made aware of the pledge through notification.

Dutch inventory is pledged pursuant to a private deed and registration of the deed with the Dutch tax authorities (or pursuant to a notarial deed). An undisclosed pledge over inventory constitutes a valid right of pledge (but it may not be possible to invoke the pledge against a third party acting in good faith).

Although specific rules exist for specific types of intellectual property rights, as a general rule, intellectual property rights are pledged pursuant to a private deed (but can also be pledged pursuant to a notarial deed). To ensure that the pledge can be invoked against third parties, for some intellectual property rights the pledge must be registered in the appropriate public registers. Because of the international nature of intellectual property rights, creating security over intellectual property rights is rarely simple and cost-effective. Therefore, pledges on intellectual property rights tend to be the exception rather than the rule.

Shares in a Dutch private company with limited liability can be pledged pursuant to a Dutch notarial deed, unless the articles of association of the company provide otherwise. If the company concerned is not a party to the deed (which it usually will be) the pledgee can only invoke the pledge against the company if the pledge has been notified to it. The pledgee shall only have the right to vote, if so provided, whether or not subject to a condition precedent (such as the occurrence of an event of default), at the time of the creation of the right of pledge or thereafter agreed in writing, and provided the transfer of the right to vote is approved by the general meeting. The articles may, however, derogate from these provisions. If the company has a works council, the works council may need to be given an opportunity to advise on the creation of the share pledge.

Registered shares in a Dutch public company that is not listed are pledged in largely the same way as described above, although formalities may differ depending on the company concerned. Pledges on other types of shares (such as bearer shares and shares included in a clearing system) are relatively rare in the context of loan financing, and are not discussed in this chapter.

**Is it possible to give asset security by means of a general security agreement?**

Separate pledges (or mortgages) must be created for the various types of assets such as Dutch real property, receivables, Dutch inventory, intellectual property and shares in Dutch companies. However, the various pledges can be combined in one deed of pledge (usually referred to as an omnibus deed of pledge). As a deed of mortgage on real property must be in notarial form and be registered in the Dutch public registers, such a deed will generally be a separate document from a deed of pledge over other asset types.
**Formalities that need to be performed**

Mortgages on Dutch real property must be registered in the appropriate public register, where the mortgage deeds are available for public inspection. Pledges on registered shares in a Dutch company must be notified to the company concerned, unless the company is a party to the deed of pledge (which would be the normal situation). The company must register the share pledge in its shareholders register, but the latter generally has no bearing on the validity or enforceability of the share pledge. The shareholders register is not open to public inspection. Undisclosed pledges on receivables and on Dutch inventory (including any supplemental deeds) must be registered with the Dutch tax authorities (unless they are in the form of a Dutch notarial deed). The purpose of the registration is to ensure that the pledge has an officially recorded date and not to facilitate levying taxes. Disclosed pledges on cash in a bank account, intercompany loans or insurance receivables need to be notified to the debtor or debtors concerned. No registration requirements apply. Pledges on intellectual property rights generally do not need to be registered to be valid. However, for some intellectual property rights registered in a public register (including patents, trade and service marks and models), the pledgor can only invoke the pledge against third parties if the pledge is registered in the appropriate register.

**Payable fees**

No registration involves significant amounts of time or expense. The costs of notarial work required in connection with mortgages on Dutch real property and pledges on shares will usually be charged as part of the legal fees. They are not dependent on the value of the underlying assets. Registration of mortgages with the appropriate public registers and of pledges with the Dutch tax authorities requires payment of nominal registration fees. For the purpose of the registration (if any) of pledges on intellectual property rights, it will often be necessary to involve a registration agency that will charge limited fees. In addition, nominal registration fees must be paid.

**Enforcement of Dutch law security**

A Dutch mortgage or pledge can only be enforced in the case of a payment default under the secured obligations. However, in the case of a disclosed pledge on receivables, subject to any limitations agreed between the pledgor and the pledgee, the pledgee may at any time exercise the right to collect the receivable, and may apply the proceeds towards satisfaction of the secured obligations as soon as they are due and payable. The same applies in the case of an undisclosed pledge of receivables, except that in this case the debtor under the receivable must first be notified of the pledge. The moment as of which the pledgee becomes entitled to disclose the pledge is generally agreed in the deed of pledge.

In practice, undisclosed pledges on receivables are enforced by the pledgee first giving notice of the pledge to the debtors of the receivables and then collecting the receivables, whereas disclosed pledges on receivables are enforced by the pledgee giving notice of enforcement of the pledge to the debtors of the receivables and then collecting the receivables.

In the case of an undisclosed pledge over inventory, again subject to any limitations agreed between the pledgor and the pledgee, the pledgee may take control of the pledged property if the pledgor or debtor does not, or if the pledgee has good reasons to fear that the pledgor or debtor will not meet its obligations. The deed of pledge may provide that the pledgee will have this right at an earlier or later stage.
Pledges on inventory are (and pledges on receivables may also be) enforced by way of a public sale. The sale requires compliance with certain procedural requirements. As an alternative, the pledgee (as well as the pledgor, unless otherwise agreed in the deed of pledge) may request the competent court to approve a private sale or to determine that the assets shall accrue to the pledgee. After a payment default under the secured obligations has occurred, the pledgor and the pledgee may also agree on an alternative manner to enforce the pledge (such as the assets accruing to the pledgee without court approval).

Mortgages on Dutch real property are enforced by way of a public sale. The sale requires compliance with certain procedural requirements that may be time-consuming. The mortgagee and the mortgagor may request that the competent court approve a private sale of the property.

Pledges on registered shares in a Dutch company are enforced in the manner set out for pledges on inventory. However, any transfer restrictions in the relevant company's articles of association must be complied with, provided that for private companies with limited liability the pledgee may exercise all rights vested in the shareholder with regard to the transfer and perform the latter's obligations in respect thereof.

A pledge on intellectual property rights is in principle enforced through sale of the rights in the same way as described above for inventory (and receivables). For certain intellectual property rights, however, specific rules apply, requiring, for example, the involvement of a civil law notary and imposing specific procedural rules.

Security created in favour of multiple creditors
The prevailing view is that Dutch law does not facilitate the granting of security on Dutch assets to more than one secured party by way of trust structures. For that reason, in almost all syndicated financings that include security interests governed by Dutch law, a ‘parallel debt’ structure is used. Under that structure, each obligor undertakes to pay to the security agent in its own name (and not as the finance parties' representative) amounts equal to the amounts owed by that obligor to all lenders under the finance documents (that undertaking being the parallel debt). Dutch security interests are then created in the name of the security agent only (and thus not also in the name of the other finance parties) to secure the payment of the parallel debt. Each finance party subsequently has a contractual claim against the security agent for payment of an amount that is determined under an intercreditor arrangement from the proceeds of the enforcement of the security interests.

Guarantees and other forms of credit support
There are many other forms of credit support available under Dutch law. Guarantees are commonly included in Dutch law-governed LMA-based (syndicated) credit facilities. The wording, with a few exceptions, generally follows the LMA English law standards. Technical changes often agreed are mainly made to ensure that the guarantee is not to be considered as a suretyship or joint and several liability. To avoid a situation – which will usually only occur if the group is in distress – where a guarantor has not benefited from the facility but has made a payment to the finance parties under its guarantee, and cannot take recourse against the borrower whose debts it has serviced, it is (from a guarantor’s perspective) advisable to create a specific arrangement on recourse between obligors. There are various options available, but whichever alternative is chosen, recourse claims between obligors generally have limited
practical relevance as long as the finance parties are not fully paid, as an LMA-based guarantee typically requires the obligors to refrain from exercising any recourse rights for as long as any amount under the facility agreement remains outstanding.

To a lesser extent, joint and several liability is assumed by obligors under Dutch law syndicated financings. That is often the case in the context of ancillary agreements relating to, for instance, cash management. In such an event, the creditor is entitled to claim payment in full from each obligor. If an obligor pays a greater share than required, that obligor is, for that greater share, entitled to take recourse against the other obligors who paid less than they were required to in their relation to the paying obligor. The obligor shall be subrogated for the excess against the co-obligors and third parties, in each case up to the share of the co-obligor or third party in accordance with the relationship with that obligor.

Also, contractually a form of credit support can be created. That can, for instance, be done by agreeing to (extensive) negative undertakings limiting various activities that the borrower may not engage in without the lender’s consent (as is common in the vast majority of financings in the Dutch market (including LMA-based financings)). In essence, such negative undertakings contractually enhance the risk profile of the borrower towards the finance parties. Examples of those undertakings are negative pledge undertakings that are routinely included in any credit facility and that also restrict the entering into of quasi-security (such as sale and leaseback transactions) and, although more common in leveraged transactions, covenants preventing dividend and other shareholder payments, which lenders will require to ensure that there is no ‘cash leakage’ from the borrower’s group.

iii Priorities and subordination

In principle, creditors of Dutch debtors have, among themselves, an equal right to be paid from the net proceeds of all assets of their debtor in proportion to their claims. Their claims thus rank pari passu. Dutch law, however, accepts the possibility of a first ranking security right, second ranking security right, etc., with respect to both mortgage and pledge, and provides for other grounds for preference (such as rights of retention, and privileges of the Dutch tax authority and a trustee in bankruptcy). Similarly, a contractual arrangement between a creditor and a debtor may stipulate that a claim of a creditor shall take, in respect of all or certain other creditors, a ranking lower than that conferred by law.

Priorities

Under Dutch law, as a general rule security that was created first in time has the highest priority. With respect to ‘invisible’ security rights (such as an undisclosed pledge on receivables) it is, therefore, important that conclusive evidence can be provided as to the date when a security right was created. This evidence is provided through the execution of a pledge in the form of a notarial deed or by registration of a private deed with the Dutch tax authorities.

In the Netherlands, no public register exists in which pledges can be filed. As a result, there is no public basis on which a creditor can verify whether any assets of a debtor are encumbered with a pledge. Therefore, a creditor cannot determine in advance whether its debtor’s assets have been pledged previously. However, mortgages are registered in a public register and thus their ranking can be determined by checking the appropriate register. Pledges on shares in a company are required to be recorded in that company’s shareholder register. However, shareholder registers are often incomplete and do not provide conclusive evidence.
Subordination

Subordination can arise directly from the law or may be agreed upon contractually between parties. An example of a subordination arising from the law is a subordination of claims of the shareholders of a company to the claims of other creditors of the company. More relevant for Dutch financing practice are forms of subordination contractually agreed as part of intercreditor arrangements. In determining the scope of a contractual subordination, the wording of the subordination clause or clauses is important, specifically to determine whether it will have an effect inside bankruptcy, outside bankruptcy or both.

Contractual subordination can be distinguished in statutory subordination and non-statutory subordination. Non-statutory subordination has effect only outside bankruptcy and comes in many varieties. In the case of non-statutory subordination, the subordination may, for example:

a. relate to the ability to claim on certain obligations or to the right to claim itself (and thus does not need to be limited to rank only);
b. ensure that a claim of the subordinated creditor only becomes due if the claims of certain senior creditors have been paid; or
c. restrict the recourse rights of the subordinated creditor to certain assets of the debtor.

In the event of statutory subordination, the debtor and creditor can, however, only contractually agree that the claim of the creditor against the debtor will be subordinated in rank to all or certain other creditors of the debtor. This specific type of subordination is laid down in the Dutch Civil Code and, necessarily, applies only in the case of insolvency (but may be combined with non-statutory subordination that applies outside insolvency). It also applies accordingly in cases of other types of concursus, particularly in the event of enforcement of security rights or attachments.

To invoke a statutory or non-statutory subordination against a debtor (in particular, to prevent that the debtor can discharge its payment obligation towards the junior creditor), a subordination agreement needs to have been entered into between the junior creditor and the debtor. From a senior creditor point of view, it is preferable that it is a party to the agreement as well. Depending on the terms agreed in a subordination agreement (such as a full subordination towards all creditors), senior creditors that were not a party to the subordination agreement may nevertheless rely on it.

A variation on the subordination described above is a type of (non-actual) subordination to which a debtor is not a party. As part thereof, it may be agreed, for instance, to not enforce certain rights or to agree on a waterfall. Such agreement cannot be invoked against the debtor and only affects the creditors that are a party thereto.

V LEGAL RESERVATIONS AND OPINIONS PRACTICE

Banks entering into a financing documented in LMA form (whether bilateral or syndicated) routinely require that legal opinions are provided to them. If multiple jurisdictions are involved (e.g., if the financing has foreign obligors), opinions from each relevant jurisdiction will be required. Customarily, opinions will be provided by counsel to the banks, although in some cases banks may accept an opinion from counsel to the borrower, or agree to a split between a capacity opinion (to be provided by counsel to the borrower) and an enforceability opinion (to be provided by counsel to the banks).
Dutch opinion practice closely follows international and European practice. Dutch opinion givers tend to limit their opinions strictly to legal matters, and therefore tend to assume all facts that cannot be independently ascertained. For the same reason, Dutch opinion givers tend not to give ‘no breach of agreements’ and ‘no violation of judgments’ opinions, which are uncommon in the Dutch market.

VI  LOAN TRADING

Most of the syndicated loans that are governed by Dutch law are documented using standard forms published by the LMA. LMA forms will typically also be utilised to document a transfer or assignment of commitments (at par or distressed) outstanding under any such Dutch law-governed syndicated credit facilities. Such credit facilities also provide to which financial entities commitments may be transferred and to what extent consent from the borrower (and within which time frame) may be required. For Dutch law-governed investment-grade credit facilities, it is often agreed that for each assignment or transfer the borrower’s consent is required unless the assignment or transfer is to another lender or its affiliate, or an event of default is continuing. In more leveraged situations, the lenders are generally allowed to more freely assign or transfer any loan commitments and with less consent requirement being applicable. The cooperation of a Dutch borrower with a transfer or assignment may also be needed if know-your-client rules require investigation of the obligors, and because the borrower will need to countersign the transfer or assignment agreement.

The Dutch Financial Markets Supervision Act includes certain restrictions that are relevant to the transfer or assignment of loans outstanding to Dutch borrowers. If the monetary threshold of (currently) €100,000 is not met (which hardly ever occurs in syndicated financings) and as long as no interpretation of ‘public’ within the meaning of Capital Requirements Directive (CRD) IV is available from a competent European authority, a facility agreement to which a Dutch obligor is a party generally prescribes that the transferee or assignee then needs to confirm to each Dutch borrower that it nevertheless is not part of the ‘public’. For most banks and other financial institutions, such confirmations should not be problematic to provide.

The parallel debt structure briefly described in Section IV, also facilitates secured loan transfers. That is because security interests created in favour of the security agent on the basis of a parallel debt will continue to secure the participation of the new lender in the secured loan following any transfer or assignment, and does not require any further documentation to be entered into or formalities to be completed.

VII  OUTLOOK AND CONCLUSIONS

In the current climate of continued economic growth in the Netherlands, Dutch banks continue to be eager to participate in new corporate and acquisition loans. In a low interest rate environment, banks’ funding costs have substantially decreased and banks are now able to lend at more competitive rates and conditions. That said, as a result of the Capital Requirements Regulation and the implementation of CRD IV in Dutch law, as is the case almost everywhere in the European Union, Dutch banks are being required to hold more capital and of a higher quality for their risk-weighted assets (and the Basel III reforms (Basel IV) proposed in December 2017 may further lift the banks’ capital requirements – in particular, for those banks that have a significant exposure to the Dutch mortgage market).
This has also led to a gradual shift towards alternative ways of financing for corporate borrowers that need longer term funding, have a higher risk profile or require big-ticket loans. The European Central Bank (ECB) guidance on leveraged transactions, which was published in May 2017, entered into force in November 2017 and, although of a policy nature only and not of a binding nature, outlines the ECB’s expectations regarding the risk management and reporting requirements for leveraged transactions, may add to this development. Alternative ways of financing accessible to medium-sized and large companies include financings by (pension) funds and insurers, private placements, securitisations, bonds issues and private debt funds (direct lending). For longer term financing, corporate bonds, US private placements, German Schuldscheins and other private placements have for some parties proven to be a viable alternative to bank financing. Similarly, investors with a longer term investment horizon (such as pension funds and insurers typically have) will likely continue to participate in loan financings that mature beyond five years (as, for instance, is often the case in public–private partnership financings).

The way that Dutch banks handle the new competition in the corporate finance market – and adapt to the new regulatory requirements and their impact on their appetite for new lending as well as funding needs of corporate borrowers – and the anticipated future decrease of the ECB’s quantitative easing and macroeconomic developments generally, will determine lending and secured finance volumes and margins in the Dutch market for the near future. Though banks are still expected in the short term to retain a dominant position, it is therefore fair to say that the Dutch loan finance market will continue to be a market in motion.
Chapter 16

NIGERIA

Kofo Dosekun, Oludare Senbore, Oritsemone Awala-Velly and Nafisa Adama

I OVERVIEW

With the rebound of crude oil prices and Nigeria’s economy slowly recovering from the economic depression experienced over the past two to three years, the appetite of banks (the main providers of finance in Nigeria) to lend is gradually increasing on the back of improvements to asset quality and stimulatory measures being taken by the federal government, especially towards shifting the focus from the country’s over-reliance on oil-generated revenue to the non-oil sector.

One such intervention is the Presidential Enabling Business Environment Council (PEBEC), which was inaugurated in 2016 to address bottlenecks impeding the ease of doing business in Nigeria. In addition, the Ministry of Budget and National Planning in April 2017 launched the Economic and Growth Recovery Plan 2017–2020 (ERGP). The ERGP is a medium-term all-round developmental initiative focused on restoring growth, investing in people and building a globally competitive economy by encouraging the diversification of the country’s sources of revenue to sectors other than the oil and gas sector.

Some key strides achieved in the period under review are summarised as follows:

a. Nigeria presently ranks 146th out of 190 economies on the World Bank’s Ease of Doing Business rankings.² The PEBEC’s goal is to promote Nigeria to the top 100 by 2020 and the top 20 by 2025.

b. Nigeria’s GDP grew by 2.38 per cent (year on year) in real terms in the fourth quarter of 2018, compared with the -2.11 per cent growth recorded in the fourth quarter of 2017 and 1.83 per cent in the third quarter of 2018.³

c. The total value of capital imported in 2018 stood at US$16.81 billion compared with US$12.23 billion in capital imported in 2017, which represents a year-on-year growth of 37.49 per cent.⁴

d. The non-oil sector contributed over 92.94 per cent to real GDP in the fourth quarter of 2018, slightly higher than the 92.65 per cent recorded in the fourth quarter of 2017.⁵

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⁴ Nigerian Capital Importation Report (Q4 and Full Year 2018) published by the National Bureau of Statistics.
⁵ Central Bank of Nigeria Communiqué No. 123 of the Monetary Policy Committee Meeting of 25 and 26 March 2019.
Another incentive witnessed during this period is the federal government’s drive to increase the utilisation of export processing zones for special development purposes, where manufacturing can be undertaken under conditions that exempt entities operating within designated zones from all federal, state and local government taxes, levies and rates. In addition to the foregoing, the Nigerian foreign exchange market, which has been volatile, is also beginning to experience relative stability – attributed to the introduction of the Investors’ and Exporters’ Foreign Exchange Window (the I&E FX Window) by the Central Bank of Nigeria (CBN) in April 2017. The I&E FX Window was set up to enable investors (including foreign lenders) to settle foreign exchange trades in a timely manner and at market driven rates. As such, the average exchange rate for 2018 stood at 360.27 naira to US$1, representing a 1 per cent depreciation from the rates in 2017.6 This has led to a stable and market-oriented pricing of foreign currency trading transactions, and an increase in foreign direct investment by US$43.89 billion in the third quarter of 2018.7 In addition, the aggregate foreign exchange inflow into the Nigerian economy amounted to US$35.28 billion in the first quarter of 2019, indicating increases of 15.5 per cent compared with the levels in the preceding quarter, and 15 per cent compared with the corresponding period of 2018.8

With the election cycle and wave of uncertainty over, the Nigerian economy is expected to pick up the pace and continue on its full recovery from the worst recession in its history.

i Recent reforms

The genesis of the steady recovery of the lending market can be ascribed to some of the economic reform programmes undertaken by the government in 2017 and further expanded upon in 2018.

The strong focus on the Nigerian domestic manufacturing sector, coupled with the provision by the CBN of specialist intervention funding to targeted sectors and the passage of certain legislation in 2017, improved the access of companies, especially small and medium-sized enterprises and manufacturing companies, to debt financing.

Specifically in 2017, the federal government signed into law the Credit Reporting Act (CRA) and the Secured Transactions in Movable Assets Act (the STMA Act).9 The objective of the CRA is to facilitate and improve the access that micro, small and medium-sized enterprises (MSME) have to finance, and enhance risk assessment and management in financing transactions. The STMA Act was enacted to govern the creation of security interests, rights and obligations of parties to registered security agreements, and sets out mechanisms for perfecting security interests in movable assets. The STMA Act establishes a national collateral registry and sets out rules for the determination of priority of competing interests in secured assets. It is the hope that the STMA Act will encourage the use of movable assets as collateral in debt financing.

The market is gradually picking up and, according to the CBN’s Economic Report for the Fourth Quarter of 2018, a total credit of 22.73 trillion naira was allocated by banks to the private sector in the fourth quarter of 2018, with a steady interest rate of 14 per cent.10

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9 The CRA and STMA Act were passed into law in May 2017.
The Credit Condition Survey Report (CCSR) of the CBN also showed that there was an increase in availability of secured credit to households, corporates and all business sizes in the first quarter of 2019. This was due to favourable economic conditions, changes to sector-specific risks and appetite to risk, and improved liquidity. The CCSR also indicated that the availability of secured credit to corporates was higher in the first quarter of 2019 compared with the fourth quarter of 2018. The survey added that secured credit is expected to grow during the second quarter of 2019 as a result of favourable liquidity positions and a higher appetite for risk.

It is the hope that adequate access to credit will in turn have a greater impact on the Nigerian economy.

ii LMA

There are a large number of Nigerian banks and law firms that are members of the Loan Market Association (LMA) and, as a result, a lot of syndicated loan agreements and even bilateral loan agreements are modelled on the LMA forms and precedents. There is an LMA facility agreement that has been drafted and agreed for naira facilities and use in the Nigerian lending market.

II LEGAL AND REGULATORY DEVELOPMENTS

i The Foreign Exchange Manual 2018

The CBN, in the last quarter of 2018, released a revised edition (the New FX Manual) of its Foreign Exchange Manual, which, with effect from 1 August 2018, repealed and replaced the Foreign Exchange Manual 2006. The New FX Manual was released with the aim of incorporating into the Nigerian foreign exchange regime contemporary developments that had taken place in the Nigerian foreign exchange market since 2006. Some of the general changes introduced in the New FX Manual reflect the technological, innovative, administrative and policy measures that the CBN has taken in recent times to align transactions in the foreign exchange market with the overall goal of the extant Monetary, Credit, Foreign Trade and Exchange Policy Guidelines in Nigeria. Some of the changes introduced by the New FX Manual include the following:

a The Chinese yuan has now been added as one of the currencies of transactions within the Nigerian foreign exchange market; the Swedish kronor and Danish kronor are no longer valid currencies within the market; and the Australian shilling has been changed to the Australian dollar.

b It is now possible to import plant, machinery and equipment into Nigeria and have them designated and classified as a ‘foreign currency loan’. Under the previous regulations, it was only possible to have them designated as ‘equity’.

c Local banks duly authorised to deal in foreign exchange will now issue an Electronic Certificate of Capital Importation (eCCI) evidencing capital importation for purposes of loans and equity investments. The eCCI has now replaced the use of the physical certificate of capital importation for the confirmation of inflow of foreign currency, capital goods and equipment.
ii Federal High Court decisions on value added tax

Pursuant to the recent Federal High Court decisions in Vodacom Business Nigeria Limited *v. Federal Inland Revenue Service*11 and Federal Inland Revenue Service *v. Gazprom Oil & Gas Nigeria Limited*,12 value added tax will now be payable by a borrower for fees payable to finance parties for transaction services (e.g., management, restructuring or agency fees) regardless of whether the service provider is a foreign entity that has not included value added tax in its invoices to the borrower. In this case, the borrower is required to compute the applicable value added tax and remit the same to the tax authority.

III TAX CONSIDERATIONS

Loan transactions, as other commercial transactions in Nigeria, are subject to Nigerian taxes. These taxes include withholding tax on interest as well as stamp duty. A brief overview of each of these taxes is given below.

i Withholding tax

Interest on loans is generally subject to withholding tax payable at the rate of 10 per cent of the relevant interest sum. However, where lenders are domiciled in countries with which Nigeria has entered into double taxation agreements (DTAs), the applicable rate of tax will be 7.5 per cent of the interest amount, pursuant to the relevant DTA. Nigeria recently ratified the double taxation treaty that it entered into with Spain, thus bringing the total number of countries that Nigeria has a DTA arrangement with to 13.

With respect to loan documentation, market practice is that loan agreements are drafted to include gross-up provisions such that the borrower is obliged to pay an additional amount to the lender with interest, to ensure that the lender receives and retains the same amount that it would have received had no tax been withheld therefrom, or otherwise due as a result of the payment. The practical effect of grossing up is that the lender receives the agreed interest sum while still fulfilling its withholding tax obligation under Nigerian law.

ii Stamp duty

The Stamp Duties Act requires any instrument executed in Nigeria – or that relates, wheresoever executed, to any property situated or any matter or thing done or to be done in Nigeria – to be stamped and the appropriate stamp duty paid in respect of the instrument.

With respect to secured facilities, the practice is usually to stamp the security document at the relevant *ad valorem* rate, and the loan agreement would then be stamped at a nominal rate of 500 naira for the original and 50 naira for each counterpart copy.

Prior to December 2016, loan agreements with respect to unsecured facilities executed in Nigeria – or that relate to any property situated, or any matter or thing to be done, in Nigeria – would usually attract a nominal stamp duty of 500 naira for an original and 50 naira for each counterpart. Deriving its powers from the Stamp Duties Act, the Federal Inland Revenue Service issued a public notice in December 2016 stating that unsecured facility agreements are to be stamped at an *ad valorem* rate of 0.125 per cent of the loan amount. Where the tenor of the unsecured loan agreement does not exceed 12 months, it can be stamped at a nominal rate of 500 naira.

11 Appeal No. FHC/L/4A/2016.
12 Suit No. FHC/ABJ/TA/1/2015.
iii Compliance with FATCA
Nigerian financial institutions comply with the Foreign Account Tax Compliance Act (FATCA) by creating FATCA compliance units to oversee and ensure that FATCA reporting requirements are met. From a transactional perspective, financial institutions may allocate FATCA risk by inserting certain clauses and representations to minimise downside risks that may occur. To assist with the above, the LMA template, which may be adopted by financial institutions, sets out information necessary to ensure compliance with FATCA.

IV CREDIT SUPPORT AND SUBORDINATION
i Security
Nigerian law recognises various types of security interests. These security interests may be created over movable assets (tangible and intangible) and immovable assets (real estate) located in Nigeria. These interests may be taken in the form of a mortgage, charge, pledge, lien or assignment, depending on the type of property.

Real estate or immovable property
Security over an immovable asset may be granted by way of a mortgage or a charge. A mortgage over land or other immovable assets may be created by way of a legal or equitable mortgage. A legal mortgage involves a transfer of the legal title in the immovable asset by the mortgagor to the mortgagee as a security for the payment of the mortgagor's debt. However, an equitable mortgage of an immovable asset is created by the mortgagor or borrower depositing the title deeds to the property with the lender, with or without a memorandum of deposit. An equitable mortgage creates a personal right against the mortgagor, which cannot be exercised without an order of the court.

A fixed or floating charge may also be created on an immovable property. A fixed charge is created over a specific immovable property of the chargor, thereby restricting the right of the chargor to deal with the asset without the consent of the chargee. However, a floating charge may be taken over a whole or specific immovable property owned by the chargee. A floating charge does not attach to a specific asset until there is a specific event that will cause the charge to crystallise.

To create an enforceable legal mortgage or a fixed charge over an immovable property, the security interest must be duly perfected as required under Nigerian law. The deed creating the legal mortgage or the fixed charge is required to be stamped (with ad valorem stamp duty being payable) and the consent of the governor of the state where the land is situated must be obtained. In addition to the requirement that the deed must be registered at the relevant land’s registry, where the party providing the security is a company, the deed must be registered at the Corporate Affairs Commission (CAC).

Shares
Similarly, security may also be taken over shares of a company incorporated in Nigeria by way of a mortgage or a charge. To take a legal mortgage over shares, the mortgagor must transfer

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legal title to the shares to the lender, on the condition that the shares will be transferred back to the borrower on repayment of the loan. The lender must be registered in the company's register of members as the owner of the shares. An equitable mortgage of shares is created by depositing the share certificates with the lender or a security trustee appointed by the lender. Where an equitable mortgage is created, legal title to the shares is not transferred to the mortgagee (bank or security trustee).

Security can also be taken over shares by way of a fixed or a floating charge. Under Nigerian law, there is no requirement to register a share charge at the CAC where the nature of the security created is a fixed charge or a legal mortgage. A floating charge over shares, however, is required to be registered at the CAC. Though a fixed charge over shares is not a registrable instrument, certain practitioners have increasingly been filing a fixed charge as a miscellaneous document at the CAC, to notify third parties that conduct a search on the records of the company creating the charge of the existence of the charge. To facilitate enforcement of the security, lenders usually require the borrowers to execute a blank share transfer form.

Security may also be created over shares that are dematerialised and kept with a central depository. The company that operates Nigeria's central depository for listed shares is the Central Securities Clearing System (CSCS). A memorandum executed by both parties requesting the CSCS to place a 'lien' on a specific quantity of shares, or all the shares of an account owner, is required to be forwarded to the CSCS. 'Lien' is used in this sense as a description for the security interest that is created over the shares or account.14 Legally, the nature of the security interest that is created is a floating charge over the shares and, as such, will require registration of the interest at the CAC if the party granting the security is a company.

Also, an undated letter signed by the party creating the security, authorising the lender to sell the shares in the event of default at the expiration of the loan due date, must be given to the lender, as the CSCS would require this document if the lender wishes to realise the security.

There is an erroneous practice in Nigeria of creating a pledge over shares. An asset can only be pledged if it is transferable by delivery of possession.15 Usually, the owner of the shares has a share certificate that evidences entitlement to the shares concerned. This is not, however, a document of title, as legal title only passes to the lender when he or she becomes the registered holder of the shares rather than mere possessor of the share certificate.16 Thus, where a party purports to create a pledge over shares, the legal effect of that is a floating charge, which could be held to be void for lack of registration.17

Bank accounts

Under Nigerian law, a security interest may be created over the money in bank accounts by way of a fixed or floating charge. A fixed charge is created over deposits in bank accounts where the parties expressly state that they have created a fixed charge over the bank account, which must be adequately and sufficiently described in the security document; and the bank or security trustee must have control of how the funds deposited into that account are managed or dealt with.

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Where the charge created on the security is a floating charge, the chargor controls the charged accounts until the charge crystallises into a fixed charge following certain events stipulated under the security document. A floating charge over cash deposits will require registration at the CAC. The registration must be preceded by the payment of stamp duty on the document creating the charge, usually at an *ad valorem* rate.

**Other assets used as security**

Security can be created over intellectual property, such as patents, trademarks, copyright and designs.\(^{18}\) Usually, parties execute a deed setting out the terms and conditions on which the security is granted.

Security may also be created over a company’s claims and receivables, which can be by way of an assignment, or a floating or fixed charge. Assignments must be in writing and must be preceded by the payment of stamp duty on the deed of assignment, at an *ad valorem* rate and registered with the CAC.

**Costs of perfection of security interests**

Where the security is immovable property, the consent of the governor of the state where the property is situated must be obtained, and this usually attracts the payment of a fee that varies from state to state. Once the governor’s consent has been granted, the security interest over the land must be registered at the relevant state’s lands registry, which also attracts a fee that varies from state to state.

With respect to companies creating security over their assets, a registration fee of 1 per cent of the sum secured is required to be paid to the CAC where the company is a private company, and a registration fee of 2 per cent of the sum secured where the company is a public company.

The stamp duty payable on a debenture deed or deed of share charge is 0.375 per cent of the secured amount. In respect of security by way of assignment, the stamp duty payable on the deed of legal mortgage and assignment is at an *ad valorem* rate of 1.5 per cent.

Nigerian law recognises the rights of parties to commercially structure their transactions to allow the security documents to be stamped for an initial amount and then subsequently upstamped for additional sums. Consequently, on a large financing, parties may agree for the security documents to be stamped to cover a certain value, which may be less than the value of the amount that has been borrowed.

**ii Guarantees and other forms of credit support**

Guarantees are a common form of security used in finance transactions. A guarantee must be in writing (or evidenced in writing) and signed by the guarantor or a person authorised by the guarantor. Where no consideration has been furnished for issuing the guarantee, it must be granted by way of a deed.

In accepting corporate guarantees, it is important to ensure that the issuance of the guarantee, as well as its value, is permitted under the articles of association of the guarantor.\(^{19}\)

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\(^{18}\) Section 197(2)(i) of the Companies and Allied Matters Act, Laws of the Federation of Nigeria 2004.

Negative pledges
Negative pledges are designed to mitigate risk to lenders by prohibiting the borrower from creating security or quasi-security over its property, without first obtaining the prior consent of the lender or granting the lender commensurate or similar security as well.

The most common forms of quasi-securities used in Nigeria include hire purchase agreements, retention of title clauses in contracts, conditional sale agreements, negative pledges and letters of comfort.

iii Priories and subordination

Priorities
Security interests are typically ranked and given priority according to the date of their creation and their nature – whether legal or equitable. Generally, a legal interest will rank in priority over an equitable interest.

A fixed charge will usually have priority over a floating charge, unless the terms on which the floating charge was granted prohibited the company from granting any latter charge having priority over the floating charge and the person in whose favour the latter charge was granted had actual notice of that prohibition at the time when the charge was created.

Where more than one creditor has the same type of security interest – for instance, where there are two legal interests over the asset of the borrower – the security interest that was registered first will rank ahead of the subsequent secured party.

With respect to security created over the assets of a company incorporated under the laws of Nigeria, where the security is not registered within 90 days of the date of creation or another prescribed period, the security becomes void against the liquidator of the company and other third-party creditors, but not the company.

Subordination
Ordinarily, contractual subordination is recognised and enforceable under Nigerian law. Creditors may agree among themselves to contractually vary the order of priority, or waive or subordinate their security interests to those of other creditors. Creditors may enter into a contractual subordination arrangement whereby junior creditors agree to subordinate their payment rights to the payment of debts due to senior creditors or agree to turn over monies collected from the debtor to the senior creditors.

However, there is significant risk that these subordination arrangements would not be enforceable in winding-up proceedings commenced against the debtor company. This is because the legal rights accruing to junior creditors in bankruptcy are not affected by such arrangements and a liquidator is not bound to adhere to the subordination arrangement.20 Under Nigerian bankruptcy laws, all unsecured creditors are ranked pari passu and the liquidator is required to distribute the assets of the insolvent company among them equally. Different rules apply to secured creditors, as they are entitled to enforce their security in satisfaction of the debt, even if the borrower is in liquidation.21

Intercreditor agreements are contracts between two or more creditors agreeing in advance on how their competing interests in their common borrower will be dealt with. It could contractually restrict junior creditors from commencing enforcement proceedings.

20 O Chukwu, O Nathaniel and Ukamaka Okoli (2017).
21 ibid.
against the debtor company, provided that any of the obligations owed to senior creditors are outstanding. In the event of a breach, the senior creditors may have a right to proceed against the junior creditors and claim any proceeds received by the junior creditors pursuant to the terms of the intercreditor arrangement.

CBN Circular No. BSD/DIR/GEN/LAB/10/009 on the Review of the Limit on Foreign Currency Borrowings by Banks (the Circular), dated 13 February 2017, stipulates that all foreign currency borrowings by a Nigerian bank must be subordinated debts with prepayments allowable only upon obtaining prior approval of the CBN. The Circular, however, does not stipulate the categories of foreign currency borrowings that are required to be subordinated and to what they should be subordinated. More clarity is therefore required from the CBN on the issue, especially as the Companies and Allied Matters Act, the Nigeria Deposit Insurance Corporation Act, the Banks and Other Financial Institutions Act and the Bankruptcy Act already set out the position under Nigerian law in relation to the priority of bank debts. Pursuant to these laws, the ranking of the debts of a Nigerian bank in the event of an insolvency is as set out below:

- **a** liquidator expenses;
- **b** depositor funds;
- **c** preferential debts, including:
  - all local rates and charges due from the company at the relevant date that became due and payable within 12 months next before that date;
  - deductions under the National Provident Fund Act 1961;\(^{23}\)
  - wages or salaries of any clerk or servant of the company;
  - wages of workers or labourers;
  - accrued holiday remuneration payable to clerks, servants, workers or labourers on termination of employment, or in the event of death; and
  - worker’s compensation (this does not apply if a company is being wound up voluntarily for reconstruction or amalgamation with another company, or if the rights due in respect of the compensation accrued before the relevant date under the Workmen’s Compensation Act);\(^{24}\)
- **d** secured debts;
- **e** unsecured debts; and
- **f** shareholders debt.

V LEGAL RESERVATIONS AND OPINIONS PRACTICE

i Legal reservations

There are some reservations with respect to financial assistance. Nigerian law prohibits a Nigerian company and any of its Nigerian subsidiaries from providing financial assistance directly or indirectly for the purpose of acquiring shares in that company.

The term ‘financial assistance’ is broadly defined to include ‘a gift, guarantee, security or indemnity, loan, any form of credit and any financial assistance given by a company, the net assets of which are thereby reduced to a material extent or which has no net assets’.

\(^{22}\) ibid.

\(^{23}\) A bill to repeal and re-enact the Company and Allied Matters Act was recently passed by the Nigerian legislature and is currently awaiting presidential assent. Once passed into law, this provision will no longer apply.

\(^{24}\) Same as above.
The consequences of failing to comply with the financial assistance rules are serious, as any transaction that represents unlawful financial assistance is void and unenforceable. Furthermore, the company and its officers will be guilty of an offence and liable on conviction to a fine.

ii Opinions practice
The typical types of opinions that are issued in a lending transaction are either: (1) a capacity and authority opinion, which confirms that the borrower has the capacity and the authority to enter into the opinion documents; or (2) a legal, valid, binding and enforceable (LVBE) opinion, which confirms the foregoing, as well as the fact that the obligations undertaken in the opinion documents are legal, valid, binding and can be enforced against the person with respect to whom the opinion is being issued.

Typically, for finance transactions conducted in Nigeria, the counsel to the lender is responsible for most of the transaction documentation, including the preparation of an LVBE opinion on the transaction. However, this does not preclude the lenders requiring that the borrower’s counsel should also give a capacity and authority opinion.

iii Choice of law and enforcement of foreign judgments
Nigerian law permits contracting parties to freely choose the law that will govern their contract, provided that the choice of law is real, genuine, bona fide, legal and reasonable, and was not made in bad faith or contrary to public policy.

The governing law of the contract would determine the construction, validity and performance of the agreement.

In the same way, foreign judgments may be duly enforced in Nigerian courts, provided they are not contrary to the public policy of Nigeria. There are two regimes for the enforcement of foreign judgments: the statutory and the common law regimes. Statutorily, the Reciprocal Enforcement of Judgments Ordinance 1958 provides for the registration and enforcement of foreign judgments in Nigeria, specifically judgment obtained from the high courts in England or Ireland, or from the Court of Session in Scotland. Thus, under the statutory regime, the courts of Nigeria will recognise and enforce (without re-examination or relitigation of the matter adjudicated upon) any judgment rendered by the high courts of England, in respect of any suit, action or proceeding arising out of or in connection with the transactions, as long as they satisfy the requirements of the Reciprocal Enforcement of Judgments Ordinance.

Under the common law regime, Nigerian law recognises a procedure whereby a judgment creditor seeking to give effect to a foreign judgment (which does not fall within the purview of the statutory regime) may institute an action for the enforcement of the judgment according to the rules of Nigerian courts. This principle of enforcement of foreign judgments through the common law route has been given judicial recognition in a number of Nigerian cases.

Foreign arbitral awards are also enforceable in Nigeria without the need for a relitigation of the facts on merits. The New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the Convention) has been given effect in Nigeria by the Arbitration and Conciliation Act, Cap A18 of the Laws of the Federation of Nigeria 2004. An arbitral award made in any country that is a party to the Convention will be enforced by the courts in Nigeria subject to the provisions of the Convention.
iv  Loan trading

Loan trading may occur with both individual and company debts.

The practice of loan trading at this time is generally through novation or assignment, where the lender transfers its rights under the loan agreement to a new lender. This new lender then assumes the position of the old lender, inclusive of its rights and obligations. This is, however, subject to the provisions of the loan documents and the required consent under the agreements between the initial lender and the borrower.

A deed of assignment or a transfer certificate is usually executed between the initial lender and the new lender, which may contain an option for the assignor to assign to the assignee the benefit of any supporting security or guarantees related to the facility agreement. The provisions of the deed of assignment must not create new obligations but should only be limited to ongoing obligations on the part of the assignor. If the original lender still has obligations under the loan agreement (such as an obligation to make further advances to the borrower), it is advisable for a deed of novation to be executed.

Parties may also adopt a risk or funded participation arrangement, whereby the lender under a loan agreement subcontracts all or part of its risk to another financial institution or individual. In respect to a funded participation arrangement, the parties agree that the participant will fund the grantor, whereas for a risk participation, parties agree that the participant will reimburse the grantor on amounts unpaid by the borrower, following a payment default under the loan agreement.

VI  OUTLOOK AND CONCLUSIONS

The Nigerian government continues to intensify effort in carrying on reform activities targeted towards improving the ease of doing business in Nigeria, which has resulted in Nigeria moving up 23 places in the World Bank’s ease of doing business ranking. One of the key areas noted in the Ease of Doing Business Report is the government's drive to expand access to credit for businesses, particularly MSMEs.

In addition to this, the House of Representatives of Nigeria passed the Companies and Allied Matters Bill (the CAMA Amendment Bill) on 17 January 2019. The CAMA Amendment Bill had earlier been passed by the Nigerian Senate on 15 May 2018 following which it was transmitted to the House of Representatives, for concurrence. It is now awaiting presidential assent. If signed into law, it is expected to reform and ease the process of establishing and managing companies in Nigeria. Under the CAMA Amendment Bill, the cost of registering security at the CAC has been reduced by about 65 per cent. Second, it sets out a massive revamp of the insolvency regime in Nigeria, and also introduces provisions that will validate netting and automatic early termination under the International Swaps and Derivatives Association master agreement and similar derivatives arrangements.

The CAMA Amendment Bill also sets out a netting procedure that allows a company to settle debts by paying only a proportion of the amount that it owes to the creditor and allows a company to come to some other arrangement with its creditors over the payments of its debts. This netting provision will serve as a means of mitigating credit risks associated with over-the-counter derivatives, and promote financial stability and investor confidence in the Nigerian financial sector.

NORWAY

Audun Nedrelid and Markus Nilsen

I OVERVIEW

Bank lending remains the main source of debt capital in the Norwegian market, although the introduction of more rigid capital adequacy rules in recent years has limited the growth in bank lending of Norwegian banks. As lending is a strictly regulated activity in Norway, any shortfall in corporate bank lending has primarily been covered by tapping into Norway’s very active high-yield bond market where the traditionally internationally oriented businesses such as shipping and offshore service suppliers, in particular, have been able to raise asset-secured debt capital. The downturn in the oil industry from 2014 to 2017 has, however, resulted in both the shipping and offshore sectors sustaining heavy losses, and substantial debt restructuring has been the result. Banks, relying on their position as first-priority secured lenders to the largest borrowers in the sectors, have nevertheless fared reasonably well during the downturn, and the lion’s share of losses has been taken by bondholders together with the shareholders. For oil and gas companies, the upturn in oil prices during 2017, which has sustained reasonably well during 2018 and into 2019, has resulted in increased investment activity by oil companies, and also in increased consolidation and mergers and acquisitions (M&A) activity – willingly funded by the banks. The largest M&A transactions in value during 2018 were from the energy, mining and utilities sectors, with a total deal value of US$3.7 billion according to Acuris. There are no immediate signs that this trend will not continue at least into 2020.

In general, Norway has a strong economy with good lending activity for unsecured corporate loans, real estate and other asset-backed financing, and for acquisition financing. Most of the major banks document their credit agreements on formats based on the Loan Market Association (LMA) standard templates, and financing based on Norwegian law is also common in large syndicates with a significant participatory presence of international banks.

The two largest Norwegian banks are DNB Bank ASA and Nordea Bank Abp, filial i Norge. DNB Bank ASA holds, together with the Norwegian branch of Nordea, a market share of around 40 per cent of the Norwegian bank lending market. The Norwegian branches of the other leading Scandinavian banks are also significant players in the Norwegian market, the most notable being Danske Bank with around 7 per cent market share.2

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2 The most recent figures for market share can be found at: www.finansnorge.no/statistikk/bank.
II LEGAL AND REGULATORY DEVELOPMENTS

Lending is a regulated activity in Norway, and a licence or a passport as a bank or other credit institution is needed to conduct lending activities. Norway is not a member of the European Union, but through the European Economic Area (EEA) Agreement it is committed to implementing the relevant directives for the finance industry. This means that the free establishment rule applies for EEA banks wishing to provide lending products and services in Norway, and for Norwegian banks wishing to provide similar products and services in the EEA.

In 2019, the European Union’s banking prudential requirements (CRD IV and CRR) will be fully implemented in Norway, thus levelling the regulatory playing field between Norwegian banks and foreign banks operating in the Norwegian market through branches or cross-border passports. Further, a legislative proposal for implementation of the European Union’s securitisation regulation in Norwegian law is expected during the second quarter of 2019. Although these legislative acts will require certain amendments to current Norwegian banking law, no radical changes to the current legislative environment for banking activities in Norway are expected.

Over the next few years, the new prudential requirements to be introduced by the European Union’s ‘Risk Reduction Package’ (which includes CRD V and CRR II) will continue to have an impact on the activities of Norwegian banks. The EU Bank Recovery and Resolution Directive (BRRD) was implemented in Norway on 1 January 2019, and it remains to be seen how the Norwegian financial supervisory authority will approach the ‘bail-in’ regime under the BRRD in relation to Norwegian banks, including in particular the requirement for in-scope banks to hold a sufficient amount of bail-in capital. Some instruments may have to be refinanced or renegotiated to qualify, and banks continue to use a substantial part of their profits to strengthen equity.

The upcoming amendments to Norwegian law and the EEA Agreement are expected to result in less ‘gold-plating’, and special Norwegian rules for banks and other financial market participants in the future. Norwegian authorities will need to pay increased attention to EEA-relevant financial markets legislation coming out of the European Union, and will have less freedom to implement bespoke domestic solutions.

III TAX CONSIDERATIONS

Norwegian borrowers are currently not subject to withholding taxes on payments to lenders. Legislative committees have suggested that Norway should also implement withholding taxes on payments on (inter alia) interest payments; however, no specific suggestion for changing the law has been proposed and it is therefore currently uncertain as to what form a withholding tax on interest on payments would take, if ever even suggested. Norway has a large number of double tax treaties with other jurisdictions where the right to charge withholding taxes to parties in the other jurisdiction is waived by Norway, and it is therefore likely that even if Norwegian authorities decide to implement withholding taxes in Norway, it will probably take some time before the legal basis for claiming withholding tax becomes effective towards lenders in a large number of jurisdictions.

To prevent tax base eruption and profit shifting out of Norway, there are limitations on the level of interest costs that are allowed for tax deduction in Norway (basically calculated as a formula on taxable earnings before interest, taxes, depreciation and amortisation of the Norwegian entities). Both interest paid to related and non-related lenders (i.e., banks and
bondholders) can at the outset be subject to a limitation of tax deduction; however, tax deduction of interest costs will be allowed for a Norwegian borrower in a corporate group if the equity ratio of the company or the Norwegian part of the corporate group is at least as high as the equity ratio of the corporate group as a whole (implying that corporate groups with only Norwegian entities will be allowed full tax deduction on interest costs). However, interest costs paid by a Norwegian borrower to related lenders outside a corporate group can still be subject to a limitation of tax deduction. In this respect, a third-party debt guaranteed by a shareholding entity of the borrower is considered incurred in respect of debt to related parties (and thereby subject to a limitation of tax deduction). As a result of this, parent company guarantees are no longer commonly part of the security package in Norwegian financings (see Section IV.ii).

No Norwegian stamp or documentary taxes are applicable in connection with the establishment, trading or enforcement of a loan under Norwegian law. Perfection or registration costs for security, and court fees for enforcement procedures are nominal only and unrelated to the amount of the loan or security in question.

The standard LMA FATCA riders are customarily included in loan agreements made under Norwegian law. Norway and the United States have entered into an agreement of automatic exchange of tax-relevant information, thereby limiting the risk of any FATCA liabilities for Norwegian lenders.

IV CREDIT SUPPORT AND SUBORDINATION

i Security

Obtaining security is straightforward and there are only nominal registration fees involved in the uptake of security. However, the financial assistance prohibitions for target companies mentioned in subsection ii will apply similarly to security granted by a Norwegian target company for the benefit of a lender of acquisition financing granted in connection with the purchase of shares in the Norwegian company or the purchase of shares in its parent company.

The most common security taken out in a Norwegian debt financing is share security, which is perfected by way of a notice to the company whose shares have been charged. As Norway has implemented the Financial Collateral Directive (Directive 2002/47/EC), obtaining share security under Norwegian law follows a similar approach to in the European Union, and pre-agreed enforcement procedures are commonly included to ensure swift enforcement of shares by way of either appropriation or a pre-agreed sales process.

Mortgages over real registered asset classes are also easily obtained by filing simple standard forms with the relevant Norwegian registry. Mortgage over real estate is obtained by filing the mortgage form with the Norwegian Land Registry, mortgages over vessels are obtained by filing the mortgage form with the Norwegian Ship Registry, and mortgages over aircraft and certain equipment related to aircraft (in accordance with the Cape Town Convention) are obtained by filing a mortgage form with the Norwegian Civil Aircraft Registry.

Generally, under Norwegian law, agreeing to a floating charge over all assets owned by a debtor from time to time is not allowed. Much of the same effect can, however, be achieved because floating charges over specific asset classes are allowed. This covers floating charges over a debtor’s trade receivables from time to time, as well as its inventory and its operating assets. These floating charges are obtained and perfected by way of filing standard forms with the Norwegian Registry of Movable Property. The floating charge over operating assets also comprises all intellectual property used by an entity in its operating business. It is also
possible to take out a separate security over patents (and applications for patents), and this security will particularly cover patents that are not used by the debtor in its own operations, but rather developed for sale or licensing to third parties.

Assignment of specific monetary claims is possible and customary under Norwegian law; however, a Norwegian company can only assign as security any future monetary claim for payment in a specifically mentioned legal relationship, with the further limitation that the contractual position as such cannot be assigned (contrary to what is possible in some other jurisdictions). Charges over bank accounts are possible, under Norwegian law, in the form of an assignment of the monetary claim against the bank for amounts deposited to the account. Such security may cover a fixed amount deposited on a blocked account or it can be a claim against the amounts from time to time standing to the credit of an operating bank account. Assignments of monetary claims are perfected by notification to the debtor of the claim.

ii Guarantees and other forms of credit support
Granting of guarantees is possible and customary in Norway; however, the granting of parent company guarantees may have adverse consequences for tax reasons (see Section III) and are therefore usually avoided if the borrower is a Norwegian entity.

Guarantees from subsidiaries are common in all types of corporate and acquisition financings. Norway, however, currently has strict financial assistance rules in force, which means that a Norwegian company may only grant guarantees or security, or advance funds in connection with an acquisition of the shares in the Norwegian entity or the parent company of the entity, with very strict limitations. The consequence of these limitations is that guarantees and security granted by a Norwegian target company and its subsidiaries will typically only extend to the amount of debt already incurred by Norwegian entities and refinanced as part of the acquisition. There is an exemption for acquisition of single-purpose entities owning real estate, which may nevertheless mortgage their properties in connection with the purchase of the shares in the single-purpose owner (thereby aligning the rules whether the property itself is sold or only the shares in a single-purpose entity with the sole purpose of owning the property). The consequence of the above exemption for real property is that acquisition financing involving real property special purpose vehicles can often obtain favourable pricing compared with other acquisitions that do not obtain a similarly strong security package. It has been suggested that the strict Norwegian financial assistance prohibitions should be softened so that Norwegian target companies and their subsidiaries should also be able to grant guarantees and security in favour of a lender to the purchaser of its shares, and it is expected that a relaxation of these rules will be adopted some time during 2019. There has been for some time, however, no clarity as to what the new rules will look like, and updated advice should be sought before structuring a financing of a Norwegian target company.

The way the financial assistance prohibition is typically dealt with under the current rules is nevertheless to obtain the usual security package over the target and its subsidiaries (as obtaining security is not costly in Norway), but adding appropriate limitation language ensuring that the security and the guarantee obligations incurred will only extend to the amount allowed possible under the law on occasion. In this way, it will be a factual matter how strong the security that is obtained from the target group turns out to be under the specific acquisition financing in question.

As a result of the above financial assistance restrictions as currently in force, lenders must rely to a larger extent on negative pledge clauses and prohibitions against additional
Norway

Financial indebtedness in the target group to get the same level of comfort. It is therefore the authors’ impression that Norwegian acquisition financings have generally had less flexibility for the borrower and its subsidiaries under Norwegian law.

The prohibition that a Norwegian target entity may not advance funds to the benefit of a purchaser of shares in the company will not prohibit the Norwegian target from distributing ordinary dividends to the purchaser.

Norwegian entities (and their boards of directors) will generally have an obligation to act in the best interest of the company, and ensure that there is sufficient corporate benefit when undertaking a transaction. This will, as a main rule, also apply to the granting of guarantees to related parties. Calculating the actual arm’s-length consideration for a guarantee or security interest under Norwegian law can be complicated, but lenders should make sure that arrangements are in place ensuring that arm’s-length provisions are paid to protect their security position, as this will typically be an assumption under the relevant legal opinions granted in favour of the lenders (see Section V).

iii Priorities and subordination

Contractual subordination is recognised and customary under Norwegian law, and may generally take two different forms. The first possibility is to agree to grant a fully subordinated loan (labelled as such), which under Norwegian law is recognised as a separate class of loan that ranks behind all pari passu debt (whether secured or unsecured), but ahead of equity claims from shareholders. In the event of a bankruptcy of the borrower, the holder of a fully subordinated loan will not be able to claim any dividend on the fully subordinated loan unless all the pari passu debt (as well as the prioritised claims, e.g., bankruptcy costs) has been paid. The second possibility is to agree to a contractual subordination and turnover in favour of another creditor (typically a bank) of claims of an ordinary claim against the borrower. In the event of a bankruptcy involving the borrower in this scenario, the holder of the loan will claim against the borrower in the bankruptcy as normal, but any dividend received from the bankruptcy estate will, in accordance with the subordination and turnover agreement, be turned over to the other party (typically the bank), in accordance with the contractually agreed terms and without involvement of the bankruptcy estate. Norway has not yet implemented the Creditor Hierarchy Directive, which implements the new class of ‘senior non-preferred’ liabilities, which rank below ordinary claims and above subordinated claims. This will likely be rectified as Norway transitions into the bail-in regime created by the BRRD.

Intercreditor agreements regulating security sharing are also customary and its content will vary depending on the structure and type of financing in question. The traditional security structure under Norwegian asset financings has been that of first and second priority security in the same asset, typically with a bank having first priority security in the asset and the junior creditors such as, for example, bondholders having second priority security. The intercreditor arrangements in such a setting would customarily revolve around enforcement rights, standstill periods and cash distribution waterfall, sometimes also with a purchase option for second priority security holders to purchase the first priority collateral position.

‘LMA-style’ intercreditor agreements are customarily seen where the structure is more akin to a financing of the whole group as such and not limited to specific assets. The concept of a security agent holding common security positions on behalf of different creditor classes is recognised under Norwegian law. The most typical structure is probably the ‘super senior’ revolving credit facility granted by bank lenders to support a borrower with working
capital facilities and secured in the same assets as a bond tranche having security on the same
priority in the same assets, but where the revolving facility takes priority in coverage from
enforcement proceeds from realising the security. However, typical LMA-style intercreditor
agreements will contain provisions that have not been tested under Norwegian courts and
may be difficult to enforce in a bankruptcy situation of the relevant obligor as the bankruptcy
estate will, as the main rule, have the possibility of electing whether to step into the position
of unfulfilled contractual obligations in a contract of a mutually burdening nature. The
obligation included in LMA-style intercreditor agreements to release intra-group claims in
the event of a default will, for example, probably not be binding upon the bankruptcy estate
unless there is a valid security interest in the intra-group claim (and if there is, as a main rule
under Norwegian law, a prohibition to pre-agree sale or transfer procedures for such security
positions). Regardless of the above, these intercreditor provisions are often entered into, and
legal opinions will contain relevant carve-outs for these kinds of provisions in a bankruptcy
(see Section V).

V LEGAL RESERVATIONS AND OPINIONS PRACTICE
The granting of legal opinions under Norwegian law typically follows the European practice
where legal counsel to the lenders grant a legal opinion both in respect of the corporate
capacity of the borrower (and guarantors) incorporated in Norway, and the legal validity
of the Norwegian law documents. The opinions are, therefore, typically granted under the
assumption that all factual matters and all signatures contained in the documents (including
on corporate resolutions and powers of attorney) are genuine and correct. Delivery of a
certificate from a director of the borrower confirming the same is commonly requested to
minimise the risk of error.

Another reservation is made with regard to corporate benefit. All transactions between
Norwegian entities should, as a matter of corporate law, be made in accordance with the
arm’s-length principle. This may imply that upstream guarantees and security granted by
subsidiaries to a parent company to secure debt obtained by the parent must be remunerated
by the parent by an arm’s-length fee or some other tangible corporate benefit to the subsidiary.
If this is not done, the consequence could be that the guarantee or security is not validly
granted and binding on the subsidiary, and may be set aside.

Norwegian corporate capacity opinions typically contain a reservation with respect to
insolvency laws in general, as a Norwegian bankruptcy estate has wide discretion to elect
whether it will enter into and fulfil unfulfilled contractual obligations under mutually
binding contracts. Although a loan agreement will not be considered mutually burdening (as
long as the loan is granted and the other party is only obliged to repay), certain intercreditor
provisions typically found in LMA-style intercreditor agreements have not been tested by
Norwegian courts and may not be upheld by a Norwegian bankruptcy estate (although
the provisions are linked to a loan agreement that must be upheld). Further, all powers of
attorney granted or contained in an agreement entered into by a Norwegian company will
not be binding on the bankruptcy estate.

Further, during an insolvency the bankruptcy estate will usually want to consider all
transactions made by the debtor in the period leading up to the bankruptcy, as the courts
will have many possibilities to set aside transactions made by the debtor prior to bankruptcy
if the transaction may be said to give preference to some creditors at the expense of others
or is made at an undervalue (or in favour of certain related parties). As a starting point,
transactions made up to two years prior to the bankruptcy may be subject to a clawback; however, in the case of transactions giving a creditor a fraudulent preference, transactions made up to 10 years prior to the bankruptcy may be set aside. Under Norwegian law, only the bankruptcy estate can approach the courts and ask that a transaction be set aside.

A few other provisions commonly contained in LMA-based loan documentation will also typically be problematic under Norwegian law and the legal opinions granted will usually include a reservation, for example, in respect of the following clauses.

‘Entire agreement’ clauses, stating that the loan agreement contains all relevant provisions of the agreement, will at the outset be upheld by Norwegian courts. They have, however, full discretion in assessment of evidence, and if the provision of the loan agreement is unclear or the matter at hand is not regulated in the agreement, a court may look at statements and other facts outside of the loan agreement to decide what the mutual understanding between the parties was. Further, clauses stating that provisions that are held to be invalid or non-binding by a court under the agreement should not affect the validity of other clauses or provisions of the agreement will not be binding upon a Norwegian court. Also, Norwegian law in general implies that where a party has a contractual right to resolve a matter in its discretion, the use of such discretion should be reasonable and will be subject to testing by Norwegian courts that the discretion has not been used to impose unfair contractual terms upon the counterparty.

Norwegian legal opinions also contain a statement that contractual obligations are enforceable under Norwegian law, with a reservation that the specific remedies available will be subject to the discretion of Norwegian courts from time to time.

Legal opinions are typically granted in favour of all the lenders at the time of entering into the financing transaction, and always with a possibility to disclose on a non-reliance basis to a wide range of other interested parties (including successor lenders in the syndicate). Sometimes reliance is also granted to new lenders following the primary syndication.

VI LOAN TRADING

Loan trading is possible and common in Norway. The main rule under Norwegian law is that a loan position can be assigned or transferred freely unless anything is agreed to the contrary in the underlying contract with between the lender and the borrower. Loan agreements commonly include the standard LMA provisions that consent of the borrower is needed unless the assignment or transfer is to another lender in the syndicate (or their respective affiliates) or to lenders on a pre-approved list of acceptable lenders. In some sectors where a higher degree of relationship lending has been common – for example, as a result of a more specific need for business or regulatory knowledge – it is sometimes seen that assignments or transfers are restricted to banks that are generally known to operate in the relevant sectors. This may, for example, be the case for loans made to companies in the oil and gas industry, which are subject to a strict regulatory regime that such borrowers would like all lenders to be aware of.

If a loan position is transferred to a successor lender, the benefit of the security position relating to the claim and held by a separate security agent will continue to secure the loan following the transfer and, as such, the security position may be said to follow the underlying claim. A security position can also be transferred under Norwegian law, so that the position as security agent may also be changed during the term of the loan.
VII OTHER ISSUES

No major changes took place in the Norwegian banking market in 2018. In July 2018, Nordea announced its acquisition of Gjensidige Bank from Gjensidige Forsikring ASA. Following regulatory approval, the deal was completed in March 2019.

VIII OUTLOOK AND CONCLUSIONS

Norway has an open and internationally oriented economy, heavily weighted towards export, and the outlook for the lending activity in the Norwegian market will to a large extent depend upon the trends in global trade and the international finance markets. The Norwegian economy is primarily influenced by the developments in the oil and offshore sectors, and, as such, fluctuations in the price of oil and gas will evidently affect activity in the Norwegian economy. Given a steady state of the international financial markets going forward, it is expected that economic activity in Norway will remain stable for the coming years, in both the bank market as well as with regard to bond issuances (where the state of the international financial markets regulates the risk appetite and thereby also the Norwegian financial markets to a large extent). One trend that has been observed specifically is a general consolidation within the offshore and shipping sectors, probably with related lending activities in respect of debt refinancing as well as availment related to acquisition financing. It is expected that this trend will also continue for the next few years.

Further, it is expected that the development of new technological solutions within the banking sector will lead to changes in the way banks operate, not only with regard to payment services but also when it comes to credit decisions and lending. As such, it is expected that, in time, fintech and digitalisation will increase competition generally in the Norwegian banking sector. New market participants (e.g., Google, Amazon and Facebook) and new techniques (e.g., fintech) for providing financial services will challenge the current market participants and practices. New techniques also bring the need for updated regulations. It is expected that fintech will have a more dominant role in the banking sector in 2019 and 2020 as compared with 2018, and that the Ministry of Finance will take steps to investigate whether the new technology and business models call for new regulations.
Chapter 18

PHILIPPINES

Vicente D Gerochi IV and Camille Angela M Espeleta

I OVERVIEW

Riding on a solid growth in private investment and public spending from previous years, the Philippines continues to weather the effects of lingering global and local uncertainties on the strength of a sound fiscal policy and a streamlined effort by the government to pursue infrastructure projects. Debt markets in the Philippines have remained robust. There are expectations of a sustained increase in business loans from corporate clients. The latest data from the Bangko Sentral ng Pilipinas (BSP) shows that, as at January 2019, corporate lending grew 15.5 per cent to 7.278 trillion pesos from 6.3 trillion pesos in January 2018.

The principal domestic pieces of legislation applicable to corporate lending and secured financing are Republic Act No. 386 (the Civil Code), An Act to Regulate the Sale Of Property under Special Powers Inserted in or Annexed to Real Estate Mortgages (Act No. 3135) and Republic Act No. 11057 (the Personal Property Security Act (PPSA)).

Commercial lending in the Philippines is typically offered by banking institutions. These are subject to the oversight of the BSP. In addition, lending companies may also be authorised by the Securities and Exchange Commission to engage in lending activities pursuant to the Lending Company Regulation Act of 2007. Typically, the operations of these lending companies are limited to small business loans and loans to retail customers.

II LEGAL AND REGULATORY DEVELOPMENTS

i The PPSA

The PPSA was enacted on 17 August 2018 to strengthen the legal framework for secured transactions in the Philippines. It provides for the creation, perfection, determination of priority, establishment of a centralised notice registry and enforcement of security interests in personal property.

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The PPSA took effect on 7 September 2018. However, its provisions have yet to be implemented pending the issuance of the implementing rules and regulations of the PPSA and considering that the law's implementation is conditioned upon the creation of a new registry, which has not yet been completed.\textsuperscript{4} The period between the effectiveness of the PPSA up to its implementation is referred to in the said law as the 'Transition Period'.\textsuperscript{5}

The PPSA covers all movable securities used in all transactions of any form that secure an obligation with movable collateral, except interest in aircraft subject to the Civil Aviation Authority Act of 2008 and interest in ships subject to the Ship Mortgage Decree of 1978.\textsuperscript{6}

The PPSA amended or repealed certain laws that are inconsistent with its provisions.\textsuperscript{7} This includes the Civil Code with respect to the creation of pledges, and the Chattel Mortgage Law with respect to the creation of chattel mortgages and registration procedures for security interests over personal property in the Philippines.

The new rules introduced by the PPSA on the creation and perfection of security interests on personal property are further discussed in Section IV.ii.

The PPSA also sets out a new set of rules for determining priority of security interest over the same collateral. Under the PPSA, the priority of security interests in the same collateral is still determined by the time of perfection; however, there are specific rules that apply depending on the nature and kind of property involved.

With respect to enforcement, there are two ways by which the security interest may be enforced under the PPSA: a secured creditor may sell or otherwise dispose of the collateral, publicly or privately; or a secured creditor may propose to the debtor and grantor to take all or part of the collateral in total or partial satisfaction of the secured obligation, subject to certain notice and consent requirements.\textsuperscript{8} The debtor is also required to satisfy any deficiency. Under previous laws governing pledges, a secured creditor is no longer entitled to recover any deficiency after a foreclosure sale.

\textbf{ii Amendments to the Manual of Regulations on Foreign Exchange Transactions}

The BSP introduced amendments to the Manual of Regulations on Foreign Exchange Transactions, which is a consolidation of all regulations governing foreign exchange transactions. The amendments are aimed to liberalise the restrictions applicable to private sector foreign currency-denominated loans, among others.

Under prior BSP regulations, prior approval must be secured to enter into a private sector foreign currency-denominated loan.

This requirement was removed in BSP Circular No. 984, Series of 2017. Under the this issuance, foreign currency-denominated loans of private sector borrowers that are not publicly guaranteed no longer require prior BSP approval to enable the borrower to service payment of the principal and interest on the loan from foreign currency purchased from the Philippine banking system. For this purpose, the BSP requires that such loans be registered with the BSP within a certain period after drawdown or utilisation of loan proceeds.

\begin{itemize}
\item \textsuperscript{4} PPSA, Section 68.
\item \textsuperscript{5} PPSA, Section 55(d).
\item \textsuperscript{6} PPSA, Section 4.
\item \textsuperscript{7} PPSA, Section 66.
\item \textsuperscript{8} PPSA, Section 58.
\end{itemize}
Further, under BSP Circular No. 1030, Series of 2019, foreign currency loans of resident private sector borrowers from banks operating in the Philippines that are not publicly guaranteed no longer require subsequent registration. Borrowers are only required to report these loans to the BSP using prescribed forms.

iii Basel III Implementing Guidelines

In December 2010, the Basel Committee on Banking Supervision introduced a set of reforms, Basel III, including standards to strengthen the definition of capital, and the introduction of capital buffers to withstand economic and financial strength. The BSP adopted these reforms in stages.

On 15 January 2013, the BSP released the Basel III Implementing Guidelines on Minimum Capital Requirements. This issuance, which took effect in 2014, sets out guidelines on the revised risk-based capital adequacy framework, specifically on the minimum capital and disclosure requirements.

In October 2014, the Implementing Guidelines on the Framework for Dealing with Domestic Systemically Important Banks under Basel III were issued to address systemic risk and interconnectedness by identifying banks that are deemed systemically important within the domestic banking industry and imposing minimum capital buffers on them.

On 9 June 2015, the BSP issued the Basel III Leverage Ratio Framework, which acts as a supplementary measure to risk-based capital requirements. The leverage ratio intends to restrict the build-up of leverage in the banking sector. On 10 March 2016, the BSP issued the Basel III Framework on Liquidity Standards – Liquidity Coverage Ratio and Disclosure Standards.

These reforms are applicable only to universal and commercial banks and their subsidiary banks and quasi-banks.

III TAX CONSIDERATIONS

i Documentary stamp tax

The National Internal Revenue Code of 1997 (NIRC), as amended by the Tax Reform for Acceleration and Inclusion Act, which took effect on 1 January 2018, prescribes the taxes applicable on loan and security transactions.

Section 179 of the NIRC provides that documentary stamp tax (DST) is due on every original issue of debt instruments at the rate of 1.5 pesos on each 200 pesos of the issue price, or a fractional part thereof.

With respect to security agreements, Section 195 of the NIRC provides that DST is due on every:

mortgage or pledge of lands, estate, or property, real or personal, heritable or movable, whatsoever, where the same shall be made as a security for the payment of any definite and certain sum of money lent at the time or previously due or owning or forbore to be paid, being payable, and on conveyance of land, estate or property whatsoever, in trust or to be sold, or otherwise converted into money which shall be intended only as a security, either by express stipulation or otherwise.

DST is based on the amount secured: if it does not exceed 5,000 pesos, DST is 40 pesos; and on each 5,000 pesos or fractional part thereof in excess of 5,000 pesos, an additional tax of 20 pesos will be imposed.
An omnibus loan and security agreement (OLSA) structure is typically used to save on DST costs. The OLSA structure is based on Revenue Regulations No. 9-94 issued by the Bureau of Internal Revenue (BIR). Under this regulation, where only one instrument is prepared, made, signed and executed to cover a loan agreement or promissory note, or a pledge or mortgage, the instrument shall be treated as covering only one taxable transaction and the DST shall be paid and computed on the full amount of the loan. This means that if a loan agreement and a pledge or mortgage is in a single agreement, the DST will be that payable on the loan (i.e., that under Section 179 of the NIRC).

ii  **Gross receipts tax**
Banks and non-bank financial intermediaries performing quasi-banking functions are subject to gross receipts tax (GRT) due on transactions within the Philippines that are covered by Section 121 of the NIRC. This Section imposes GRT at the rates of 1 to 5 per cent on interest, commissions and discounts from lending activities of banks and non-bank financial intermediaries performing quasi-banking functions depending on the remaining maturities of instruments from which such receipts are derived, and 7 per cent on other items of gross income.

In practice, GRT is shifted or ‘passed on’ to borrowers through contractual stipulations in the loan agreement, notwithstanding that under the NIRC banks and non-bank financial intermediaries performing quasi-banking functions are directly liable for GRT.

Revenue Memorandum Circular No. 62-2016, issued by the BIR, provides clarification on the proper tax treatment of GRT. Under this issuance, if the GRT is contractually passed on to the borrower, the passed on GRT paid by the borrower to the bank will be treated as receipt of gross income and shall itself be subject to GRT. To illustrate, if the recipient is a bank, the interest received by the bank under a loan agreement that provides that the borrower shoulders the GRT on the interest shall be subject to GRT at the rate of 5 per cent. The borrower will remit this passed-on GRT to the bank along with the interest due. The amount of passed on GRT shall form part of the other items of gross income, which itself is subject to 7 per cent GRT.

This would result to a situation where GRT is imposed on the reimbursement of GRT. To address this and ensure that all GRT is passed on to the borrower, lenders typically incorporate the GRT in the computation of the applicable rate of interest on the loan.

iii  **The Foreign Account Tax Compliance Act**
On 13 July 2015, the Philippines and the United States signed the Agreement between the Government of the United States of America and the Government of the Republic of the Philippines to Improve International Tax Compliance and to Implement FATCA (PH–US FATCA IGA), which is a reciprocal intergovernmental agreement to implement provisions of the Foreign Account Tax Compliance Act (FATCA) to promote transparency in financial accounts between the two nations for tax purposes.

Specifically, Philippine financial institutions will need, among other things, to perform due diligence procedures for new and pre-existing individual and entity account holders that meet a certain threshold, and report the total amount of gross income paid or credited to accounts of US account holders.

FATCA reporting will not take place until the PH–US FATCA IGA has been concurred in by the Senate and has entered into force. President Duterte ratified the PH–US FATCA IGA on 1 December 2016 and it was transmitted to the Senate for concurrence, where it remains pending.
IV CREDIT SUPPORT AND SUBORDINATION

i Security

Real estate

Security may be taken over real property by way of a real estate mortgage.

The primary laws governing the creation, perfection and foreclosure of a mortgage on real property are the Civil Code and Act No. 3135. Under Article 2085 of the Civil Code, to constitute a mortgage it is necessary that the mortgagor be the owner of the item mortgaged. Generally, there is no specified form to the mortgage agreement. The document is not required to be registered in the Registry of Deeds for validity. The registration of the security interest and annotation in the certificate of title (if the mortgaged item is land) will bind third parties, and constitute public notice to third parties on the creation of the security interest from the date of its recordation. Nevertheless, an unregistered mortgage is binding between the parties.9

A real estate mortgage may be foreclosed extrajudicially or judicially. Extrajudicial foreclosure may be made where a clause is inserted in the contract giving the mortgagee the power, upon default of the mortgagor, to foreclose the mortgage by an extrajudicial sale of the mortgaged property (Act No. 3135, as amended by Act No. 4148, Section 1). The sale should be made after giving notice and should be at a public auction, in the province in which the property is situated.

Owing to foreign ownership restrictions on land, a foreign mortgagee cannot bid or purchase land at a foreclosure sale. Its right is limited to receiving the net proceeds from the sale.

Security interest on personal property

The PPSA introduced new rules governing the creation of security interest over personal property in the Philippines and registration of such security interests.

Under the PPSA, a security interest over personal property is created through a ‘security agreement’.10 A security agreement must be in writing, signed by the parties and shall provide for the language to be used in the agreements and notices.11 There is no requirement under the PPSA that the security agreement be in a public instrument, but it is advisable given the practical effects of placing documents in a public instrument (i.e., admissible in court as evidence without the need for further proof of its authenticity). A security agreement may provide for the creation of a security interest in future property, but the security interest in that property will be created only when the grantor acquires rights in it or the power to encumber it.12 In creating a security interest, it would be sufficient that the collateral be reasonably identified, whether in a general or specific manner.13

The PPSA provides that security interest over personal property may be perfected to bind third parties through the following means: registration of a notice with the registry, possession of the collateral by the secured creditor, or control of the investment property or deposit account.

9 Civil Code, Article 2125.
10 PPSA, Section 5(a).
11 PPSA, Section 6.
12 PPSA, Section 5(b).
13 PPSA, Section 7.
A security interest in a tangible asset may be perfected by registration or possession, whereas a security interest in an investment property or deposit account may be perfected by registration or control.

ii Guarantees and other forms of credit support

Corporate guarantees are typically provided by parents and affiliates of a borrower. A Philippine company can guarantee a debt of the borrower provided that the guarantor is authorised to give the guarantee under its articles of incorporation and has obtained the requisite corporate approvals.

iii Priorities and subordination

Priority of security interests

The priority of security interests in the same collateral is generally determined by time of perfection. However, with respect to security interests over personal property, there are rules for determining priority for specific types of properties.

Deposit accounts

For a deposit account or investment property where the secured creditor is the deposit-taking institution, the order of priority is as follows:

a deposit-taking institution’s right to set-off against the deposit account;
b creation of a security interest in favour of the deposit-taking institution or the intermediary;
c conclusion of a control agreement; and
d registration. 14

Certificated securities

For security certificates, the order of priority is as follows:

a possession; and
b registration. 15

Intermediated securities

For electronic securities not held with an intermediary, the order of priority is as follows:

a notation in the books maintained by or on behalf of the issuer;
b conclusion of a control agreement; and
c registration. 16

Instruments and negotiable documents

For an instrument or negotiable document, the order of priority is as follows:

a possession; and
b registration. 17

14 PPSA, Section 18(a) to (d).
15 PPSA, Section 18(e).
16 PPSA, Section 16(f) to (h).
17 PPSA, Section 19.
Debt subordination

Banks may only issue unsecured subordinated debt to the public with prior approval from the BSP. Banks applying for such authority must comply with the minimum amount of capital under Section 101 and, if it will be offered to the general public, the issuing bank must be rated by an independent credit rating agency recognised by the BSP.18

Unsecured subordinated debts shall be issued in minimum denominations of 500,000 pesos or its equivalent in foreign currency.19

V LEGAL RESERVATIONS AND OPINIONS PRACTICE

i Effect of the PPSA on existing security arrangements

Although the PPSA became effective on 7 September 2018, its implementation is conditioned upon the registry being established and operational.20

This has significant practical effects in determining the applicable rule governing the creation and perfection of security interests over personal property during the Transition Period (which is where we currently are). For instance, a security interest may have been created prior to the PPSA being effected and perfected afterwards. Alternatively, a security interest may have been created during the Transition Period and perfected after the creation of the registry. The PPSA does not provide for the mode of perfecting security interests created prior to the PPSA being effected during the Transition Period.

Under the PPSA, the creation of ‘prior interest’ is determined by prior law, and a prior interest is effective between parties, notwithstanding its creation not complying with the requirements of the PPSA.21 In this regard, ‘prior interest’ is defined as a security interest created or provided for by an agreement for another transaction that was made or entered into before the PPSA was effected, and that had not been terminated before the PPSA was effected, but excludes a security interest that is renewed or extended by a security agreement or other transaction made or entered into on or after the PPSA was effected.22

ii Financial assistance

There are no laws that prohibit a company from granting financial assistance for the purpose of the acquisition of its shares or those of a parent company. The same may be conducted provided that the corporation is duly authorised to engage in such activities under its articles of incorporation and the necessary corporate approvals are obtained.

iii Opinions practice

The counsel of the borrower, mortgagor or pledgor is commonly required to issue a legal opinion addressed to the lender confirming legal capacity; due authorisation of the borrower or obligor to enter into a loan agreement; the validity and enforceability of the agreements; compliance with applicable laws; and the creation and perfection of the security interests.

A legal opinion confirming the above may also be required from the lender’s counsel.

18 Manual of Regulations for Banks, Section 126.
19 ibid.
20 PPSA, Section 68
21 PPSA, Section 56.
22 PPSA, Section 55(c).
iv  Choice of law and enforcement of foreign judgments

As a rule, a choice of law in a contractual agreement would be recognised by a court in the Philippines, provided there are substantive factors that justify the choice (e.g., part of the contract was performed in that jurisdiction, a party is a resident of that jurisdiction).

A Philippine court may disregard the parties’ choice of law and apply the laws of the Philippines (1) with respect to matters bearing upon the authority and capacity of any Philippine national to enter into and perform the transactions contemplated by the activities, (2) in determining compliance of the activities with all requirements of governmental approvals in the Philippines and (3) in determining compliance of the activities with the formalities required under Philippine law for the conveyance of, and the creation of security interests in, property situated in the Philippines.

Moreover, if a suit is instituted in the Philippines, the foreign law must be proven in accordance with Philippine rules on evidence (i.e., the relevant piece of foreign legislation must be shown to exist). In this regard, a certificate of the person having custody of the official publication of the statute must be presented, which must be authenticated by the seal of the secretary, embassy, legation, consul general, consul, vice consul or consular agent, or by any officer in the foreign service stationed in the foreign country in which the record is kept. If a party fails to prove the foreign law, the foreign law will be presumed to be the same as the Philippine law on the matter pursuant to the doctrine of processual presumption.

As a rule, foreign judgments are presumed to be valid and binding, and may be enforced in the Philippines. However, a judgment against a Philippine national by a foreign court could be rejected by a Philippine court if (1) the foreign court did not have jurisdiction in accordance with the jurisdictional rules of the foreign court, (2) the Philippine national had no notice of the proceedings, or (3) the judgment of the foreign court was obtained through collusion or fraud, or was based on a clear mistake of law or fact.

VI  LOAN TRADING

Loan trading may be done by novation, assignment or participation.

An assignment of credit is the process of transferring the right of the assignor to the assignee who would then have the right to proceed against the debtor.23 In novation through subrogation, the third party pays the obligation of the debtor to the creditor with the latter's consent. As a consequence, the paying party replaces the original creditor as subrogee of the latter.24

Assignment by the borrower of its rights and obligations in a loan agreement is typically allowed with the prior consent of the lender, or, in the case of a syndicated loan, all the lenders.

It is also typical to allow participations in a loan agreement, whereby a lender or a borrower shall be allowed to assign, transfer or sell a participation in all or any part of the loan advance or commitment, subject to consent requirements and minimum denomination. In the case of participations, there shall only be a total of not more than 19 lenders at any one time, otherwise the participating interest created may be deemed a security that will require compliance with the Securities Regulation Code.

There appears to be no established secondary market for loan trading in the Philippines. Loan trading is commonly negotiated between or among parties.

VII OUTLOOK AND CONCLUSIONS

On the production side, growth in 2018 was driven by the industry and services sectors, particularly the construction and retail trade and related services. Loans for production activities – which comprised 88.8 per cent of banks’ aggregate loan portfolio – increased by 15.8 per cent, and this growth was driven primarily by increased lending in construction activities (35.9 per cent) and financial and insurance activities (30.6 per cent).

Determined effort by the Philippine government to pursue infrastructure projects is expected to result in a more robust and vibrant debt market in the Philippines, with borrowers, including government institutions, increasingly seeking funding. This, in turn, is expected to produce a higher growth potential and healthier economy, consistent with stable inflation conditions; paired with the passing of new laws, including the PPSA, and the relaxation of foreign exchange rules in the country, this promises to result in a more robust market for corporate lending in the Philippines.
I OVERVIEW

Following years of financial turmoil, the Spanish economy has been recovering steadily since 2014. GDP growth was 2.6 per cent in 2018, well above the euro area average. This trend is expected to continue in 2019 and 2020, albeit at a more moderate pace. Spain, like other European Union Member States, faces both political and financial challenges in the near future. Deleveraging the private and public sectors and achieving higher productivity are still priorities. Although unemployment has significantly decreased since the crisis, Spain still has one of the highest unemployment rates among the Western economies. Likewise, Brexit has opened a door to unknown risks that will need to be addressed. Elections have been held at both national and regional levels, with negotiations to form a national government ongoing at the date of this publication.

Spanish banks have benefited from Spain’s steady growth, as well as from access to liquidity and low funding costs, which have facilitated new lending activity. The Spanish banking sector currently meets applicable regulatory capital requirements and is in a comfortable liquidity position. However, Spanish banks, like international banks, continue to be exposed to the pressures of increasing regulation, low interest rates and increased competition. Innovation and shadow banking are also big challenges. As a consequence, further integration and measures to reduce costs and improve capitalisation are expected.

Although the non-performing loan (NPL) ratio for Spanish banks has declined to close to the EU average, Spanish banks have continued to be very active in selling loan portfolios and distressed real estate assets. The sale of NPL mortgage portfolios in Europe rose in 2018, recording a historical amount of €205 billion, the Spanish market being one of the main contributors totalling 21.05 per cent of all transactions. Several institutions are following a ‘large-scale deals’ strategy. As an example, Banco Sabadell agreed to transfer two portfolios of real estate assets to Cerberus, with a total gross book value according to public sources of almost €9.1 billion, and Lone Star acquired two portfolios of real estate assets from CaixaBank and Bankia, with a total gross book value of €12 billion and €1.65 billion, respectively.

1 Ángel Pérez López, Pedro Ravina Martín and Blanca Arlabán Gabeiras are partners at Uría Menéndez Abogados, SLP. The authors thank David López Pombo (partner) and Borja Contreras (principal associate) for their contribution to this chapter in their respective areas of practice.

2 According to the European Economic Forecast published by the European Commission in May 2019, the performance of the Spanish economy is set to continue in 2019 and 2020 with GDP growth of 2.1 per cent and 1.9 per cent respectively, while GDP growth is expected to be 1.9 per cent and 1.5 per cent in the eurozone.

3 CBRE.
Large restructuring transactions have continued to play an important role, although they are less prevalent while the Spanish economy remains stable. In 2018, significant deals closed or were still in process – some of which are the continuation of previous restructuring processes (among others, Abengoa). In 2018, a number of restructured companies closed their first post-restructuring financing transactions (e.g., FCC).

Meanwhile, the use of leveraged loans to finance merger and acquisition (M&A) activity has increased (e.g., in the first five months of 2019 alone, six takeovers of listed companies have been either authorised or approved, including in respect of Telepizza, NH Hotel Group, GAM, Parques Reunidos, Bodegas Bilbaínas and Natra). Furthermore, a large number of companies have refinanced their debt or issued bonds, including in a high-yield format bonds (including Cirsa, eDreams, El Corte Inglés and Gestamp Automoción).

Project finance activity is also due to increase, particularly as new policies that boost public spending in infrastructure and green projects are put in place (particularly in renewable energy). The year 2018 marked a new record in the issuance of green bonds in Spain.

II LEGAL AND REGULATORY DEVELOPMENTS

In recent years, one of the main aims of Spanish legislators has been to amend the Spanish Insolvency Act to introduce mechanisms that incentivise out-of-court restructuring and facilitate a fresh start for both companies and individuals. Since 2003, the Spanish Insolvency Act has been amended over 17 times. Among other things, ground-breaking amendments were gradually approved to (1) allow companies to delay the insolvency filing for four months once they communicate to the courts that they are negotiating a composition or refinancing agreement with their creditors; (2) protect creditors from clawback risk if a refinancing agreement complies with certain requirements; (3) facilitate the cramming down of dissenting creditors in out-of-court restructuring processes, provided that a refinancing agreement is approved by the courts; and (4) allow for the faster sale of companies subject to insolvency proceedings.

This trend is to continue as the General Codifying Commission is currently drafting a consolidated Spanish Insolvency Act, which will likely introduce important amendments to the insolvency regime. Although as at the time of writing it is unclear when this consolidated text will be approved, it will probably incorporate further amendments to the insolvency procedure regarding preventive restructuring tools (including, in particular, majorities, cross-class cramdown and allowing the sale of the entire business of an insolvent debtor as a going concern).

Recent consumer-friendly court rulings present further challenges for banks. In December 2016, the European Court of Justice (ECJ) ruled that ‘floor clauses’ (being clauses in Spanish mortgage contracts that set a minimum interest rate) were unfair to consumers. Controversially, the ruling had retroactive effect, and a significant volume of mortgage contracts executed prior to the ruling were impacted. Similarly, the Spanish Supreme Court, in its judgment of 23 December 2015, declared that clauses that impose all the expenses of creating a mortgage on the client to be null and void. Furthermore, provisions that allowed for the acceleration of loans made to consumers upon payment default have been widely challenged and considered to be abusive by the Spanish Supreme Court and the ECJ. On 26 March 2019, the ECJ issued a long-awaited judgment regarding the acceleration of loans secured by residential mortgages. In this ruling the ECJ clarified that the use of the ‘blue pencil rule’ is not permitted and that courts, therefore, are not allowed to retain those parts
of the clause that are deemed valid and delete those that are null and void (which was a solution that had been used to allow the continuation of enforcement proceedings). The ECJ has, however, left the door open to replacing the clauses that are deemed to be null and void with legal provisions if it is established that the mortgage loan would not remain in force without the offending clause. This solution is not entirely satisfactory and will no doubt lead to further litigation. At the same time, the Real Estate Credit Agreements Law was enacted on 16 March 2019 to partially transpose into Spanish law the protective regime set out in Directive 2014/17EU of 4 February 2014 regarding credit agreements for consumers relating to residential real estate. The main purposes of the Real Estate Credit Agreements Law are to increase legal certainty, avoid any lack of transparency regarding real estate credits and reduce the litigiousness associated with certain unfair contractual clauses. Although these rulings and consumer regulations should not apply to corporate lending, they are expected to have a significant impact on Spanish banks.

On 13 February 2018, the National Commission on Markets and Competition (CNMC) fined four major Spanish banks a total of €91 million for colluding to fix the price of interest rate derivatives attached to syndicated loans above market price. The decision is an additional indication that syndicated loans are coming under the scrutiny of competition authorities. On 5 April 2019, the European Commission published a long-awaited report on loan syndication and its impact on competition in credit markets in the European Union, focusing on six countries (including Spain). The report concluded that certain practices could give rise to concerns about collusive behaviour and included recommendations to avoid those behaviours.

On 23 May 2019, Decree-Law 9/2019 was passed in Catalonia to lift some restrictions that applied before to the creation of Catalonian pledges (i.e., those granted over assets located in Catalonia). Among others, the creation of concurrent pledges and pledges of different rankings is expressly allowed (thus deleting a historical restriction that had little justification) and further flexibility is included in relation to the enforcement of pledges.

### III TAX CONSIDERATIONS

The main corporate tax chargeable on interest and other amounts receivable under a loan is corporation tax, which applies to the entire income obtained by the taxpayer. Interest received should therefore be included with all the other income generated by the lender. Interest must be included within the corporation tax base when accrued. The accrual principle for tax purposes follows International Financial Reporting Standards rules. The general corporation tax rate is 25 per cent (30 per cent for credit institutions).

Borrowing costs are deductible expenses for corporation tax purposes. Borrowing costs include interest of any kind, transaction costs and other similar expenses, and may be deducted when accrued.

Nevertheless, the tax deductibility of interest payments is contingent upon some limitations, namely:

- Interest paid on participating loans in which the lender and the borrower are members of the same group of companies is not deductible.
- Interest paid on loans in which the lender and the borrower are members of the same group of companies is not deductible if the funds borrowed are used to buy shares, where the seller is an entity that is also a member of the same group of companies, unless the taxpayer proves that the transaction has a valid commercial rationale.
Net interest paid in any financial year, to the extent that it exceeds 30 per cent of operating profit in respect of that financial year, is not deductible. Net interest means the excess of financial expenses over financial income. Operating profit is calculated in a similar way to earnings before interest, tax, depreciation and amortisation (EBITDA). Any net financial expenses that have not been deducted in one financial year can be carried forward to future financial years with no time limit, subject always to the 30 per cent limit in respect of each fiscal year. This limitation is not applicable to, inter alia, credit institutions or insurance companies.

The deductibility of interest paid in any financial year on loans used to acquire shares is generally limited to 30 per cent of the EBIDTA of the acquiring company in respect of that financial year. However, this limitation should not apply: (1) in the tax year in which the acquisition is executed to the extent that the acquisition is financed with a maximum debt of 70 per cent of the acquisition price; and (2) in the following tax years, should the loan be reduced, proportionally, on an annual basis within the following eight years, until the debt is 30 per cent of the acquisition price.

Interest paid is generally subject to withholding tax at the rate of 19 per cent. Withholding taxes applied on interest payments to taxpayers who are residents of Spain are refundable from the corporate tax of the recipient. In addition, some interest payments to Spanish residents are exempt from withholding tax, for instance:

- interest paid to entities that are exempt from corporation tax (e.g., Spain, its political subdivisions and its administrative agencies, including the Bank of Spain);
- loan interest paid to banks and certain other financial institutions;
- loan interest paid to securitisation funds; and
- interest paid between entities belonging to the same tax consolidation group.

Withholding tax levied on the payment of interest to taxpayers who are not resident in Spain is not refundable, but there are some exemptions from withholding tax:

- interest paid to EU residents is exempt; and
- interest paid to non-EU residents who are residents in a jurisdiction with which Spain has a double tax treaty may, under the applicable treaty, benefit from withholding tax reductions or exemptions.

The granting and negotiating of loans and credits as part of an economic activity is a supply of services that is subject to, but exempt from, value added tax. No other taxes are due upon the execution of a corporate loan agreement.

Mortgages are subject to stamp duties ranging between 0.25 per cent and 1.5 per cent (depending on the Spanish region in which the mortgaged asset is located) on the total amount (principal, interest, default interest, etc.) secured by the mortgage.

The assignment of loans or credits secured by a mortgage is generally subject to stamp duty, unless made in a private agreement (i.e., a document not having access to the Land Registry). This is why it is not uncommon in the Spanish market for mortgaged credits to be assigned in private documents and notarised upon the borrower’s default (i.e., when there is a need to enforce the mortgage).

In 2013, the United States and Spain entered into an intergovernmental agreement to provide for the implementation of the US Foreign Account Tax Compliance Act (FATCA). FATCA requires financial institutions (FFIs) outside the United States to report certain
information on US account holders to the US tax authorities. If those FFIs fail to report the required information (non-participating FFIs), a 30 per cent tax would be withheld on, inter alia, their US source income.

The Loan Market Association (LMA) published and subsequently amended a template investment-grade facility agreement, including FATCA provisions that are generally used in cross-border transactions and by Spanish lenders and borrowers. In summary, the FATCA provisions include the following:

- defined terms;
- the obligation to provide FATCA information (that is, mainly, whether the parties are exempt from FATCA; and
- FATCA gross-up clauses.

The gross-up obligation varies depending on who should be protected from FATCA withholding. However, it is now market practice that borrowers should not make additional payments in the event of FATCA withholding because it only arises when the lender is a non-participating FFI; therefore, the risk of FATCA withholding is essentially one that can be mitigated by the lender. In addition, when the transaction requires a paying agent, it is common to include provisions requiring the resignation of the agent if the agent becomes a non-participating FFI. Therefore, the practice in Spain does not differ substantially from that that is followed in other jurisdictions.

IV CREDIT SUPPORT AND SUBORDINATION

Financing transactions governed by Spanish law are frequently secured by security interests and guaranteed by personal guarantees that will generally only be enforced by the security agent (to avoid partial foreclosures by any creditor). As the legal concept of the security trust does not exist under Spanish law, the agent will need to prove that it has been duly and expressly empowered\(^4\) to carry out this enforcement.

i Security

Pledges

Pledges are created over movable assets, and possession of the collateral must be transferred to the pledgee.

Standard pledges include pledges over shares and pledges over credit rights (e.g., those arising from the balances in bank accounts, operational agreements, insurance policies or hedging agreements).

Real estate mortgages

Real estate mortgages are created over any real estate, and must be executed in a public deed before a notary public and registered with the land registry where the asset is located. Real estate mortgages generate significant costs and taxes.\(^5\)

Spanish law provides for the possibility of creating a floating mortgage, which is a security interest created over a specific real estate asset to secure an amount of liabilities up to a maximum cap. Floating mortgages can only be granted in favour of financial institutions

\(^4\) The power of attorney will need to be notarised and, where appropriate, apostilled or legalised.

\(^5\) These costs include stamp duty (described in Section III), notarial fees and land registrar fees. The calculation base for these costs is the total amount secured by the mortgage.
and public authorities (and in the latter case, exclusively to guarantee tax or social security receivables). The floating mortgage deed must include a description of the actual or potential secured liabilities, the maximum mortgage liability (which will cover all the obligations without allocating mortgage liability to each of them), the term of the mortgage, and the method of calculating the final secured amount and balance payable.

**Chattel mortgages and pledges without displacement**

Chattel mortgages can only be created over:

- business premises;
- cars, trains and other motor vehicles;
- planes;
- machinery and equipment; and
- intellectual and industrial property.

There is a specific type of mortgage for ships (naval mortgage). The chattel mortgage must be executed in a public deed before a notary public and registered with the Movable Assets Registry.

Pledges without displacement can only be created over:

- harvests;
- animals on plots;
- harvesting machinery;
- raw materials in warehouses;
- merchandise in warehouses;
- art collections; and
- credit rights held by the beneficiaries of administrative contracts, licences, awards or subsidies, provided that this is permitted by law or the corresponding granting title, and over receivables (including future receivables) not represented by securities or qualified as financial instruments.

Pledges without displacement must be executed in a public deed before a notary public, and registered with the Movable Assets Registry.

Except for pledges without displacement over credit rights and inventories, these security interests are seldom used in Spain, mainly because:

- the pledgor or the mortgagor would not be able to sell the relevant assets without the pledgees’ or the mortgagees’ consent, respectively;
- most of the assets that can be mortgaged with a chattel mortgage (mainly those that are not movable) can be covered by a real estate mortgage if expressly agreed to by the parties in the real estate mortgage deed; and
- in most cases, the assets that cannot be covered by a real estate mortgage are not valuable enough to warrant the cost of creating the chattel mortgage.

**Financial collateral**

Financial collateral secures the fulfilment of principal financial obligations. Although the meaning of this expression has been subject to debate among academics, the most common construction is that obligations pursuant to almost any financing document can be secured by financial collateral. Financial collateral can consist of cash or securities and other financial instruments, and certain types of credit rights held by credit institutions. Therefore, financial
collateral could comprise shares issued by public limited liability companies – although some academics doubt whether shares in non-listed companies can constitute financial collateral – and credit rights arising from the balances in bank accounts.

This type of security interest (1) may benefit from a separate enforcement if the debtor becomes insolvent, and (2) as regards pledges over shares, can be foreclosed by a private sale (instead of in a public auction, as is the general rule under Spanish law) conducted by the depository of the shares or by the pledgee’s direct appropriation of the shares. This is in contrast to the general Spanish law principle that prohibits any form of foreclosure of a security agreement that enables the holder of the security interest to directly and immediately acquire the secured asset.

ii Personal guarantees

Normally, the borrower’s shareholders and each of its subsidiaries provide, to the extent permitted by law (specifically, the financial assistance prohibition and conflict of interest restrictions), first demand guarantees or other types of personal guarantees in respect of the fulfilment of the obligations assumed by the borrower under the financing documents.

A personal guarantee may be created by agreement between the creditor and the guarantor, or by operation of law. To facilitate the enforcement of a personal guarantee against a Spanish company, a settlement clause establishing the method of calculating the outstanding debt is usually included.

In the absence of an agreement to the contrary, a guarantor cannot be obliged to pay the beneficiary of the guarantee until all the debtor’s assets have been realised. However, this restriction does not apply as follows:

a. if the guarantor has waived the restriction;
b. if the guarantee is joint and several;
c. if the debtor is declared insolvent; or
d. if the debtor cannot be sued in Spain.

Additionally, all exceptions and defences available to the debtor as against the creditor will also be available to the guarantor.

First-demand guarantees, which are not regulated by law, are separate and independent from the main obligation, create a primary liability on the guarantor and are not subject to the debtor’s assets being realised. Lenders usually request that all personal guarantees created under the finance documents be first-demand guarantees.

iii Priorities

Security interests are governed by the principle that security created earlier has priority over that created later. With respect to real estate mortgages, chattel mortgages and pledges without displacement, priority is determined by the date (and time) on which they are registered with the public registry, which is deemed to be the date (and time) on which the relevant document was submitted for registration. With regard to pledges, which are not registered in any public registry, priority is determined by the date (and time) on which possession is transferred. However, Spanish law allows creditors to agree on the priority of pledges and real estate mortgages. Therefore, creditors can agree that all the credits have the same priority or different ranking.
Pursuant to the Spanish Insolvency Act, in the context of bankruptcy proceedings, secured credit rights will benefit from priority up to the value of the collateral. The creditor is generally considered an ordinary creditor in respect of the excess.6

iv Subordination

Notwithstanding this, if a secured credit is classified as a subordinated credit, the benefit of any priority arising from the security is lost. Under Spanish law, subordination can arise ex lege (as a matter of law) or ex contracto (from a contract).

Contractual subordination is recognised in Spain in accordance with international practice. Contractual subordination provisions used in Spain are similar to those used in other jurisdictions.

Spanish insolvency law provides for the subordination of certain claims by operation of law. These subordinated claims include, among others, the following:

a claims that are not notified by the creditors to the insolvency trustee in a timely manner;

b claims that are contractually subordinated to all remaining claims of the debtor;

c claims for interest; and

d most importantly, all rights against the debtor held by legal or natural persons who qualify as ‘specially related’ to the debtor. This category includes, among others, shareholders with a stake of 10 per cent in the insolvent entity (5 per cent if it is a listed company) when their credit right arose, formal directors or shadow directors, and companies of the insolvent entity’s group.

There is also a rebuttable presumption that any person who acquired a credit against the insolvent debtor from any of those related parties in the period of two years prior to the commencement of the bankruptcy proceedings is a related party for insolvency law purposes.

V LEGAL RESERVATIONS AND OPINIONS PRACTICE

Standards applicable to the issuance of legal opinions in Spain are not very different from those applicable in other jurisdictions. In pure lending transactions, legal opinions are usually issued by counsel to the lenders or arrangers, except when capacity opinions are requested from counsel to the borrowers. This also applies in plain vanilla bond issuances. On the contrary, in high-yield bond transactions it is usual that legal opinions are issued by counsel to the arrangers or initial purchasers and by counsel to the issuer. Limitations apply to disclosing legal opinions to third parties other than the initial addressees. Disclosure without reliance may be permitted in some cases (e.g., if required by law or a court order, or to auditors or rating agencies on a need-to-know basis). Exceptionally, disclosure with reliance is permitted

6 In the context of bankruptcy proceedings affecting Spanish companies, creditors will be divided into two categories: bankruptcy creditors and creditors against the insolvency estate. The list of creditors against the insolvency estate is closed and includes expenses incurred in the proceedings and essential basic expenses for the debtor to continue in business (e.g., salaries, utilities), and these creditors will be paid before any uncharged assets are distributed to the bankruptcy creditors. The claims of bankruptcy creditors may be classified as privileged, ordinary and subordinated. Privileged claims may, in turn, be deemed specially or generally privileged.
during the syndication of the loan, but this is normally restricted to a very short time frame, and is subject to limitations and restrictions (including a requirement for the disclosing entity to notify the opinion provider of such disclosure).

Below is a description of the main issues and most frequent legal reservations in practice in Spain.

i  Corporate benefit
Directors of Spanish companies have a general duty to act loyally and diligently, in compliance with applicable law, and in the best interests of the company.

It is not always straightforward to prove that providing security or guarantees in the context of a group financing is in the best interests of a company. This question ultimately turns on the facts of the relevant transaction.

Accordingly, corporate benefit should be analysed on a case-by-case basis considering, among other things, the structure of the group, the nature and amount of the guarantees provided, the purposes of the financing and the direct and indirect consideration received by the relevant guarantor. With regard to downstream guarantees, corporate benefit may be easier to prove. However, courts have been less willing to recognise corporate benefit in the case of upstream or cross-stream guarantees.

ii  Clawback
According to the Spanish Insolvency Act, any action taken or agreement reached in the two years preceding the declaration of insolvency of a company can be rescinded by the court if the receiver can prove that the action or agreement was ‘detrimental to the insolvency estate’. ‘Detrimental’ is not defined and has been construed rather broadly by the courts. The Spanish Insolvency Act also provides for certain circumstances in which a detriment to the insolvency estate is presumed to exist. Among others, unless proven otherwise, the granting of security in respect of pre-existing or refinanced debt is presumed to be detrimental to the insolvency estate. Moreover, debt prepayment (with some exceptions in secured loans), gifts and other benefits for no consideration are automatically presumed to be detrimental.

However, the Spanish Insolvency Act provides some safe harbours for the refinancing of existing debt, which is protected from clawback risk subject to compliance with specific formalities and majority thresholds, which differ depending on whether the refinancing agreement has been subject to court sanction.

iii  Financial assistance
Companies are generally prohibited from providing financial assistance for the purchase of shares. Breaching this prohibition could entail both liability for directors and the nullity of the transaction in which the financial assistance was provided.

Acquisition finance transactions have been structured to comply with the restrictions on financial assistance by creating separate debt tranches and implementing a debt push-down by way of a forward merger. As from 2009, however, a specific regulation applies to forward mergers whereby if two or more companies merge and any of them has received financing within three years prior to the acquisition of a controlling stake in, or essential assets of, any of the companies that are part of the merger, some protective measures apply. Among others, the directors must issue a report justifying the merger, and an independent expert must issue
a fairness opinion confirming that the transaction is reasonable and that there has been no financial assistance. This provision has been subject to much debate, especially in relation to the scope and effects of the report issued by the independent expert.

iv Security trustee and parallel debt

Spanish law does not recognise the concept of a ‘security trustee’ who is the holder of legal title to the security package and enforces the security package on behalf of the lenders from time to time. Thus, legal title over a security interest must be held by each creditor under the secured facility.

Furthermore, any parallel debt governed by Spanish law is unlikely to be considered valid, since under Spanish law contracts and obligations are only valid and enforceable if they are based on a valid and legitimate reason.

In view of the above, lenders in secured syndicated loan transactions typically provide a notarised and (in the case of foreign lenders) apostilled power of attorney in favour of the security agent to enable it to lead a coordinated enforcement process on behalf of all the lenders.

v Acceleration

In the Spanish market, the decision to accelerate a loan and enforce the security is usually a last resort once all other alternatives such as debt restructuring have failed. However, the courts have traditionally been reluctant to uphold loan acceleration and the subsequent enforcement of security if the default is not deemed to be material. In this regard, to be able to enforce a mortgage, at least three principal instalments must be outstanding or a payment default must be outstanding for at least three months. Although it is believed that these provisions should only apply to mortgage-backed loans with consumers, the position is currently unclear.

The recent Real Estate Credit Agreements Law also includes a detailed and mandatory regulation for the acceleration clauses if there is a payment default of a mortgage loan by consumers.

VI LOAN TRADING

The assignment of a lender’s participation under a facility agreement governed by Spanish law may be carried out by:

a assigning the credit rights, which would result in transferring to the assignee the credit rights held by the assignor against the borrower (but not the contractual obligations assumed by the assignor as regards the borrower); or

b assigning the contractual position under the agreement to any third party, and thus the relevant rights and obligations.
Therefore, assigning the contractual position under an agreement would be relatively similar to a novation under English law, as it entails the transfer of both rights and obligations, and the subrogation of the assignee to the contractual position of the assignor. However, the previous contractual relation does not need to be terminated.

No specific formalities need to be complied with for an ordinary transfer to be effective between the parties. However, under Spanish law, the transfer date must be certain and unambiguous for it to be fully effective regarding third parties. Therefore, it is very common to formalise the assignment agreement in a public deed before a Spanish notary public. Furthermore, a notice must be served to the debtor to guarantee the assignee that any payment made by the debtor to the assignor will not release the former from its obligations as regards the assignee. Recent amendments to the legislation of the autonomous regions of Catalonia and Valencia require that a notice shall be served to the debtor (and, if applicable, to the relevant mortgagor) to inform of the assignment and of the main terms and conditions of the assignment, including, in particular, the price paid by the assignee to the assignor. Other amendments introduced to the legislation of the autonomous regions of Castilla La-Mancha and Extremadura require that a notice shall be served if the relevant credit is assigned to a securitisation fund within a securitisation (i.e., not if the credit is transferred to the assignee through a direct assignment). The drafting of these amendments is rather obscure and the consequences of not serving these notices are unclear.

Spanish notarial documents are essentially public deeds, which must be used, among other things, for any transaction that requires registration with a land registry, and public policies, which can only be used to formalise contracts of a commercial and financial nature corresponding to the ordinary course of business of at least one of the parties.

Although the creation and assignment of mortgages must be documented in a public deed, other types of security interests are usually documented in a public policy. The creation or assignment of a mortgage, when documented in a public deed, triggers stamp duty, which must be paid and the mortgage registered for it to be able benefit from the advantages established under Spanish law (particularly, an expedited enforcement proceeding). In turn, pledges without displacement, which must be registered with the Movable Assets Registry, may be documented in public policies (and thus no stamp duty accrues).

Moreover, some Spanish security interests cannot be assigned to every type of creditor. Floating mortgages can only be assigned to financial institutions and public authorities (and in the latter case, exclusively to guarantee tax or social security receivables), and financial collateral can only be assigned to:

- credit entities;
- investment services companies;
- insurance companies;
- collective investment in transferable securities;
- mortgage securitisation funds, asset securitisation funds and their managing entities;
- pension funds; and
- financial institutions.

Spanish tax authorities have recently issued two binding resolutions stating that the total amount secured should be understood as the outstanding amount of the facility as of the effective date of the assignment and not as its mortgage liability, as was the case beforehand. This may have an impact on transactions in which mortgage-secured facilities have been partially repaid by the debtors and on past transactions (the assignees may consider requesting a refund of any excess stamp duty paid).
In practice, this constitutes an additional restriction on the Spanish debt trading market.

Syndicated facility agreements governed by Spanish law usually provide for a specific form of assignment agreement, which is used by lenders when carrying out any assignment of their participation in the loan. They also set out the conditions under which an assignment may be carried out without the debtor’s consent. Although the lenders’ aim is to make the above-mentioned conditions more flexible, the borrower usually wishes to limit the concept of ‘permitted assignee’ or ‘permitted assignment’ for the financing to remain under the control of its banks, namely the banks with which it has a special relationship and is familiar.

It is not unusual for creditors to close the terms and conditions of the assignment pursuant to LMA trade forms, but executing trade confirmations is generally supplemented by executing the form set out in the facility agreement or any other assignment agreement governed by Spanish law that is subsequently formalised in a public deed. This requirement is particularly important to evidence the title to claim the assigned indebtedness and enforce the security interests and personal guarantees. This is especially relevant for movable or immovable mortgages and pledges without displacement, where the creditor must be a registered creditor.

The financial crisis created a market from what was previously an ancillary practice to financing transactions. Spanish financial institutions are carrying out several competitive processes to transfer single names when they are not confident about a particular economic sector or about the debtor’s ability to recover financially. Likewise, credit rights are sometimes grouped together (according to the type of security attached to them or the nature of the debtors) to allow purchasers to acquire groups of hotels, offices or shopping centres by enforcing the relevant mortgages.

Moreover, the financial crisis left a significant number of debtors (both individuals and small and medium-sized enterprises (SMEs)) unable to repay their debts to the banks, thus impairing the banks’ default rates and causing them to significantly increase their reserves. Although the volume of NPLs has gradually decreased, Spanish financial institutions still hold high volumes of NPLs and continue be very active in launching competitive processes to sell large portfolios of NPLs, whether secured or unsecured. These have attracted interest from large investment funds and have also led to the creation of an ancillary industry comprising servicers who specialise in credit claims and foreclosed asset management.

As a notable development in this market, the General Directorate of Registries and Notaries has clarified that the assignee of a mortgage loan has the right to request the issuance of a new copy with enforcement effects of the loan, provided that the relevant assignee, among other things, has not previously requested this type of copy for the same loan. This clarification has been welcomed and will significantly facilitate one of the key negotiation points in this type of transaction. Not having these copies could prevent the assignee of the loan from acceding to an expedited enforcement process. Before this consultation, it was unclear whether notaries were able to issue second copies with enforcement effects when the previous copies were unavailable or had been lost by the assignors. Assignors were reluctant to assume strong commitments regarding the delivery of original documentation and the risk of not having all the copies with enforcement effects, particularly for mortgage portfolios that were not enforced, could lead to a decrease of the price paid by the assignee and lengthy discussions that can now be avoided.
VII OUTLOOK AND CONCLUSIONS

The continuous growth of the Spanish economy, coupled with banks cutting costs aggressively in the search for deals, has resulted in an increase in lending activity. Overall, banks have enjoyed continued profitability, with the exception of a one-off factor related to the resolution of Banco Popular.8 Restructuring transactions are bound to decrease, while project finance, M&A deals and leveraged loans are increasing. The financial sector is still highly dependent on lending; however, companies are increasingly issuing bonds or using alternative financing sources.

Spanish institutions, as any other EU institutions, are facing increasing challenges in 2019 owing to low interest rates, increasing regulations and the existence of other sources of financing, which are becoming real competitors to traditional bank lending, not only for large multinational Spanish companies but also for SMEs. Banks will have to monitor very closely the effects that these challenges may have on their businesses and activities, and manage their response to innovation and new competition simultaneously with the completion of their own reorganisation processes, focusing on their traditional business and continuing with the divestment of their non-core assets. Competitive processes for the sale of single names, NPLs and real estate portfolios are expected to continue during the second half of 2019, particularly following the format of large-scale deals.

The way that Spanish banks handle the current challenges and adapt to new regulatory requirements will determine lending and secured finance volumes for 2019. Banks will need to anticipate and manage potential risks and identify new opportunities that may arise in the near future.

8 Statement by the staff of the European Commission and the European Central Bank following the ninth post-programme surveillance visit to Spain.
I OVERVIEW

The corporate lending market in Sweden has been fairly active in recent years, mainly driven by excess liquidity in the market and a generally favourable economic cycle. In recent years, increased diversification of the debt capital markets in Sweden has been evident. The main reasons for that diversification are the evolution of a domestic (or regional) corporate bond market and the introduction of new debt products such as unitranche facilities.

Traditionally, the corporate lending market in Sweden has been dominated by domestic and pan-Nordic banks. That has, in particular, been the case since the financial crisis in 2008 when a number of international banks ended their presence in Sweden in favour of shifting focus back to their main markets. However, the increased competition from the bond market and from credit funds has led to challenges to the dominance of the local banks, and it is likely that the diversification and competition among market participants will continue.

Borrowers have benefited from the excess availability of debt capital through lower margins and better contractual terms. However, some of the more aggressive terms that have been prevalent in the London and New York markets have yet to materialise in Swedish deals. For example, lenders are generally still looking for maintenance financial covenants by non-investment grade borrowers and Swedish deals with incurrence-based covenants are fairly rare (the exception being deals syndicated in the international capital markets with Swedish borrowers or sponsors).

The Loan Market Association’s (LMA) recommended forms for facilities agreements are widely used in Sweden, in particular in syndicated or club deals. The recommended forms require fairly limited adaptation to work under Swedish law. In addition, on bilateral deals, abridged versions of the LMA documents are sometimes used.

II LEGAL AND REGULATORY DEVELOPMENTS

Lending as such is not a regulated activity in Sweden outside of a consumer context. However, if the entity extending loans also accepts deposits from the public, that constitutes a regulated financing activity, which requires a permit in Sweden (either directly from the Swedish Financial Supervisory Authority (FSA) or through EU passporting rules). Further, if the lending activity is considered to be fairly regular, the entity may be regarded as conducting

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1 Eric Halvarsson and Fredrik Gillgren are partners at Hamilton Advokatbyrå.
a permanent financing business in Sweden; in this case, the FSA must be notified. Although
the regulatory situation is not entirely clear, more incidental lending to Swedish borrowers
does not usually require notification.

Banks are licensed and supervised by the FSA. Sweden has implemented Basel III through
the Capital Requirements Directive IV. In addition, banks are subject to even more strict
capital adequacy requirements imposed by the Swedish government. Swedish banks are all
ranked very high compared with other European banks\(^2\) when looking at capital adequacy
after imposing stress tests, mainly because of high capitalisation combined with low default
rates on loan assets.

Financial institutions are required to pay a resolution fee to a government resolution
reserve. The resolution fee is similar to a bank levy. Effective 1 January 2018, financial
institutions are also required to comply with certain minimum requirements of eligible
liabilities as part of the government’s resolution and stability planning. The idea is that
institutions shall maintain a minimum of own funds and liabilities that can be used to cover
losses and restore the capital base in the case of failure of the institution.

Swedish financial institutions are required to comply with international sanctions
that are applicable in Sweden, being sanctions imposed by the United Nations and the
European Union. As a consequence, loan agreements now typically include mandatory
prepayment requirements, events of default and undertakings, which apply in the case of
sanctions-related events. The clauses are often subject to negotiations between borrowers and
lenders. Similarly, loan agreements will typically include representations and undertakings in
relation to anti-corruption laws.

### III TAX CONSIDERATIONS

Interest income for lenders that are tax-domiciled in Sweden is taxed as corporate income
tax at a rate of 22 per cent. A lender would be tax-resident in Sweden if it is incorporated
in Sweden in accordance with the Swedish Companies Act. Non-resident companies with
a permanent establishment in Sweden or that own real estate are taxed on Swedish-source
income. This is, however, subject to double taxation treaties, of which Sweden has entered
into many.

Sweden does not levy any withholding tax on interest payments. For that reason, tax
gross-up clauses in loan agreements are usually quite simple, although the standard LMA
concepts of qualifying lenders are sometimes included. Sweden does, however, subject to
exceptions and tax treaties, impose withholding tax on dividends.

Interest on debt incurred to credit institutions and other third-party lenders is fully
deductible for Swedish companies. However, interest expense on debt owed to affiliated
companies is not deductible unless the affiliated receiver of the interest income is taxed at a
rate of at least 10 per cent, or if the debt has been incurred primarily for ‘business reasons’.
The latter test may be difficult to pass as the tax authorities will look at whether the financing
could have been provided by other means; for example, through shareholders’ contributions
or subscription of new shares. Consequently, borrowers with foreign holding company
structures may have to carefully consider whether the interest expense under intercompany
loans will be tax deductible at all. In the absence of thin capitalisation rules in Sweden, the

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\(^2\) See, for example, the European Banking Authority 2018 EU-wide stress test results.
limits on tax deductibility in respect of intercompany loans have been one of the tools for the government to limit tax avoidance by setting off Swedish income against high interest expense on intercompany loans from, potentially, low tax jurisdictions.

There is currently an ongoing oversight of the Swedish corporate taxation regime. However, the main pieces of legislation are yet to be proposed to Parliament.

For the purpose of the US Foreign Account Tax Compliance Act (FATCA), Sweden has entered into an agreement with the US government and also enacted legislation for the purpose of complying with the intergovernmental agreement. The Swedish agreement is based on Model 1 of the intergovernmental agreement models. As a consequence of the implementation in Sweden, FATCA is normally not an issue in Swedish corporate lending transactions.

IV CREDIT SUPPORT AND SUBORDINATION

i Security

General

If security is to be taken over assets located in Sweden, it is important to have the security created in accordance with Swedish law. Though Swedish courts may recognise the validity of a security interest created under a non-Swedish law governed security document, assuming it is valid under the law governing the security document, the enforceability in Sweden is nevertheless subject to the requirement that necessary actions to create and perfect the relevant form of security under Swedish law have been taken.

Security can be created over nearly every type of asset. However, it is not possible to create security over all or substantially all of the assets of a particular company under a single all-asset-encompassing security document, and, hence, security must be taken on an asset-by-asset basis.

Below is a brief overview of the common methods of taking security over certain assets; namely, how security over these assets is typically created, perfection requirements and the extent of any registration, tax or other costs involved.

Real estate

Security over real estate is created by way of a mortgage and registration with the Land Registration Authority. Upon an application by the legal and registered owner of a real estate, the registration authority issues mortgage certificates, which, when pledged and handed over to a creditor, represent a security right with a certain value and a certain priority. Mortgage certificates can be issued in either paper or electronic form. A mortgage certificate in electronic form will be regarded as handed over to the creditor when it has been transferred to the creditor’s account in the mortgage register (or to the account of a third party representing the creditor) kept by the Land Registration Authority. The electronic mortgage system is available to local banks only.

Certain assets (e.g., machinery) may be regarded as industrial accessory equipment or fixtures, and would then be covered by a mortgage.

In essence, the security interest created by a mortgage entitles the secured creditor to payment out of the proceeds from a sale of the relevant real estate up to an amount equal to 115 per cent of the amount of the mortgage certificates issued and held by it as security.
The issuance of a new mortgage certificate attracts a stamp duty cost of 2 per cent of the amount secured (i.e., the face value of the mortgage certificate). However, any mortgage certificates already issued can be pledged again without incurring any additional stamp duty.

**Tangible movable property**

The only practical way to create security over tangible movable property is by way of a business mortgage. The reason is that security by way of a pledge over such property requires the transfer of possession of the property, and the pledgor must be excluded, both legally and practically, from dealing with the pledged property. Consequently, it is difficult to obtain perfected security over tangible movable property other than through a business mortgage.

A Swedish company may file an application with the Companies Registration Office for the issuance of business mortgage certificates, which, when pledged and handed over to a creditor, represent a security right with a certain value and a certain priority. Business mortgage certificates can be issued in either paper or electronic form. A mortgage certificate in electronic form will be regarded as handed over to the creditor when it has been transferred to the creditor’s account in the business mortgage register (or to the account of a third party representing the creditor) kept by the Companies Registration Office. The electronic business mortgage system is available to local banks only.

A business mortgage covers all of the pledgor’s movable property (other than cash at hand and bank deposits, shares and other tradable financial instruments and securities) used in the pledgor’s business. However, security by way of a business mortgage does not prevent the pledgor from disposing of the relevant assets, and it is also subordinate to other perfected pledges over the same assets, even if such pledges are created after the business mortgage. A debtor may pledge, for example, receivables that form part of a pre-existing business mortgage, and the pledge of the receivables will then rank ahead of the business mortgage.

A business mortgage gives the secured creditor a specific right of priority enforceable in bankruptcy and execution. A secured creditor who holds a business mortgage certificate is, in conjunction with a levy of execution or bankruptcy, entitled with the right of priority to which the business mortgage is entitled pursuant to law, to receive payment for its claim from the assets covered by the business mortgage up to the face amount of the business mortgage certificate (plus a supplement).

The issuance of a new business mortgage certificate attracts a stamp duty cost of 1 per cent of the amount secured (i.e., the face value of the business mortgage certificate). However, any business mortgage certificates already issued can be pledged again without incurring any additional stamp duty.

**Shares and financial instruments**

Security over shares and other financial instruments is created by way of a pledge. A share pledge is perfected by transfer of possession of the relevant share certificates (if the relevant shares are in certificated form and share certificates have been issued) to the pledgee (endorsed in blank) or, if no share certificates have been issued, through notification of the pledge to the company’s board of directors.

If the shares or other financial instruments are in dematerialised registered form and held on a securities account, perfection is made by registration with Euroclear Sweden or, if held on a deposit account, through notification of the pledge to the account bank. Other financial instruments that are not in dematerialised form (i.e., in bearer form) require transfer of possession to be perfected.
Contractual rights and receivables

Security over contractual rights and receivables is created by way of a pledge. The pledge is perfected through notification to the contractual counterparty or receivable debtor, as applicable. If the receivables are in the form of a bearer promissory note (or similar), the pledge is perfected by transfer of possession of the relevant promissory note to the pledgee (endorsed in blank). Proceeds are to be paid directly to the pledgee and the pledgor may not have control over any account to which payments are made.

Security over receivables may be cumbersome for the pledgor as it must have no disposal rights in respect thereof. A pledge requires that the secured creditor has total control over the payment of the receivables, meaning that all debtors must be notified of the pledge and instructed to pay to an account that is not controlled by the pledgor.

Security over receivables can also be created by way of a business mortgage.

Cash deposits

Security over cash deposits on bank accounts is created by way of a pledge. The pledge is perfected through notification to the account bank. The pledgor must not be allowed to withdraw funds standing to the credit of the pledged account without the express consent of the secured creditor.

For practical reasons, it may be undesirable to block the bank account, and the parties may, therefore, sometimes agree that the pledge over the bank account will not be perfected until the occurrence of an event of default (or similar triggering event). However, non-perfected security will be subject to a three-month hardening period from the date of perfection and could be clawed back in a following bankruptcy.

Intangibles and intellectual property rights

Security over patents and trademarks is created by way of a pledge registered with the Patent and Registration Office. No similar registration is available for copyrights and, given that there is no counterparty or official registry to which a notification of a pledge can be given, this form of security may not be created over copyrights or goodwill.

Security over patents and trademarks can also be created by way of a business mortgage, which would also cover copyrights and goodwill.

ii Guarantees and other forms of credit support

Guarantees are common in Swedish secured (and unsecured) lending transactions. There are no formal requirements, but guarantees are normally made in writing. It is common to include the guarantee in the loan agreement and to make the guarantor a party to the loan agreement. Separate guarantees – either unilateral or documented in an agreement – are also common if, for some reason, the guarantor will not be a party to the loan agreement.

Negative pledge undertakings are commonly included in both loan agreements and security documents.

iii Priorities and subordination

Contractual and structural subordination are common ways to ensure a certain priority order. On more complex leveraged finance transactions, an intercreditor agreement will regulate the priority of debts and security, whereas in lesser structured transactions, a short-form subordination undertaking or agreement may be used. Under the intercreditor or
subordination agreement, the parties will contractually agree on a certain order of priority. The ranking of security is normally dealt with in the relevant security documents (i.e., the security provider will grant first and second ranking security to certain creditors, in either the same security document or in separate security documents), and will be underpinned by the intercreditor or subordination agreement.

Structural subordination (i.e., where the creditors lend to different entities in the corporate structure) is common on mezzanine transactions, although there has been a firm pushback from mezzanine lenders on structural subordination.

Intercreditor agreements have not been fully tested by Swedish courts, so there is uncertainty as to whether some of the provisions of standard intercreditor agreements will be upheld (in particular, release provisions in respect of subordinated debt). Further, in the case of formal bankruptcy proceedings involving a Swedish company, the bankruptcy administrator can elect whether the estate will be bound by the intercreditor agreement.

In the case of the insolvency of a borrower being declared bankrupt, the ranking and priority is dependent on the type of claim. There are three main types of claims, namely claims with special priority (e.g., secured claims, claims secured by mortgage and claims secured by seizure), claims with general priority (e.g., claims given priority because of public interest) and claims without priority.

Within the group of claims with special priority, the claims will be entitled to be paid out of the proceeds from a sale of the assets being subject to the relevant security.

If any assets remain after the claims with special priority have been discharged, claims with general priority will be discharged out of the remaining assets. Within the group of claims without priority, all claims rank equal in priority (pari passu) and will be discharged pro rata.

V LEGAL RESERVATIONS AND OPINIONS PRACTICE

i Legal limitations on validity and enforceability

Financial assistance restrictions are fairly strict and apply to loans, security and guarantees.

In general, a company may not grant loans or provide security or guarantees for loans granted to (1) a person who is a shareholder, director or managing director (including its respective relatives) of the company or another company within the same group of companies, or (2) legal entities controlled by any such person.

There are a number of exceptions to this general restriction – the most widely used is when the entity whose obligations are being guaranteed is an entity within the same group as the company providing the financial assistance. This exception also applies where the parent entity is a foreign legal entity similar to a company and domiciled within the European Economic Area.

However, even if the financial assistance falls within this exception, if it takes the form of security or guarantees, the security or guarantees must also comply with the Swedish transfer of value rules, which apply to, for example, upstream and cross-stream security and guarantees. Under those rules, a company must generally not undertake a transaction without deriving real and adequate corporate (commercial) benefit from it. Thus, when a company is providing security or a guarantee for a third party’s obligation, it must be considered whether the company gains any benefit from the transaction. A guarantee without sufficient corporate benefit may nonetheless be valid if the value of the guaranteed amount does not, at the time when the guarantee is provided, exceed the amount available for distribution by the company as dividends.
In addition, a company may not provide financial assistance, by way of either an advance, a loan or security, or guarantees for a loan granted to a debtor for the purpose that the debtor shall acquire shares in the company, or shares in its (direct or indirect) parent company or any other company placed above or at the same level as the company in the group structure. Consequently, a Swedish company may not normally guarantee or provide security for debt incurred for the purpose of financing an acquisition by the debtor of the shares in the Swedish company or its Swedish parent company.

The prohibition applies to financial assistance given before or simultaneously with the acquisition of shares, but not after the acquisition. Therefore, a loan, security or guarantee, or any other financial assistance provided after the acquisition, where the funds are used to pay for the acquired shares or repay financing incurred in connection with the acquisition, will not be prohibited. The period that must lapse between the acquisition and the financial assistance to avoid the prohibition is unclear and must be established on a case-by-case basis. However, to be on the safe side, the period should be at least three months. There is no whitewash procedure available under Swedish law.

ii  Legal opinions practice

Legal opinions as to matters of Swedish law are regularly delivered on international, cross-border and syndicated loan transactions, but rarely on purely domestic bilateral or club deals with all-Swedish lenders. Creditor counsel would typically deliver the opinion, both as to capacity and authority of any Swedish obligors and enforceability of any Swedish law-governed transaction documents, but sometimes both debtor and creditor counsel deliver the opinions (debtor counsel as to capacity and authority, and creditor counsel as to enforceability). Opinions are typically addressed to, and capable of being relied upon by, the original lenders or finance parties named in the loan agreement, and sometimes also parties that become lenders in connection with primary syndication or within a certain period from signing or first utilisation. Copies of opinions may typically be disclosed for information purposes only to (but not be relied upon by) parties that may potentially become lenders, their and the addressees’ auditors, legal and other professional advisers and persons to whom an addressee is required to disclose the opinions under applicable law, without consent of the opining counsel.

iii  Choice of foreign law and recognition and enforcement of foreign judgments

The choice of foreign law as the governing law of a loan agreement or security document will typically be recognised and upheld as a valid choice of law by the courts of Sweden (subject to the provisions of Regulation (EC) No. 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations).

A final and conclusive judgment rendered by a court in a contracting state to: (1) Council Regulation (EC) No. 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (the Brussels I 2000 Regulation), in respect of legal proceedings instituted before 10 January 2015; (2) 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 (the Brussels I 2012 Regulation), in respect of legal proceedings instituted on or after 10 January 2015; (3) the Convention on jurisdiction and the enforcement of judgments in civil and commercial matters made in Brussels on 27 September 1968 (as amended) (the Brussels Convention); or (4) the Convention on jurisdiction and the enforcement of judgments in civil
and commercial matters made in Lugano on 16 September 1988 (the Lugano Convention), which is enforceable in such state, will be recognised and enforceable by the courts of Sweden according and subject to the Brussels I 2000 Regulation, the Brussels I 2012 Regulation, the Brussels Convention or the Lugano Convention, as applicable.

To enforce a judgment under the Brussels I 2000 Regulation, the Brussels Convention or the Lugano Convention, the concerned party must submit an application for enforcement to the Svea Court of Appeal and comply with the procedures of that court (as required).

According to Swedish case law, a judgment given by a court in a state not being a contracting state to the Brussels I 2000 Regulation, the Brussels I 2012 Regulation, the Brussels Convention or the Lugano Convention would only under certain circumstances be recognised and regarded by a Swedish court as evidence of the outcome of the dispute to which the judgment relates, and a Swedish court would still, even if such circumstances were found to be applicable, have the possibility to rehear the dispute ab initio or may consider the judgment to be a matter of legal fact upon which a Swedish court may render its own judgment, inquiring only as to whether all procedural aspects in the applicable courts of the non-contracting state have been observed.

VI  LOAN TRADING

Most Swedish corporate loan agreements include transfer provisions, and loan participations are traded in Sweden similarly to other jurisdictions. As novation is not a recognised legal concept in Sweden and may have the result of restarting a hardening period for security, assignments and transfers are the recommended methods for transferring loan participations. Under Swedish law, an assignment of rights under a contract requires notice to the contract party (i.e., the borrower in a loan agreement context), so loan agreement clauses should ensure that the borrower is notified of any transfers.

Under a standard Swedish loan transfer clause, a proportional interest of any security interest is also transferred. That is sufficient to ensure that the related security will benefit the assignee from the transfer date.

Sub-participation and other forms of transfers without changing the lender of record are possible and common in the market. However, a sub-participation will normally not be legally enforceable against the borrower (as it is not notified of any transfer of rights), and the transaction is, therefore, dependent on the contractual terms between the lender of record and the sub-participant. The borrower will continue to make payments to the lender of record and will discharge its obligations by paying to the lender of record.

VII  OUTLOOK AND CONCLUSIONS

As discussed in Section I, the diversification of the Swedish market is likely to continue. Although Swedish banks are well capitalised and profitable, banks will be under pressure from increased costs for capital requirements and other regulatory initiatives. This will probably continue to drive the market entry by other participants, such as Swedish and foreign credit funds and other alternative debt providers, such as insurance companies and similar. Swedish and pan-Nordic banks have generally been able to offer very competitive pricing on corporate loans and, thus, been able to hold onto a significant market share compared with, for example, international financial institutions. Though it is likely that the banks will continue to be the main source for funding for Swedish borrowers, there is certainly scope for foreign and domestic debt providers to originate and execute loan transactions in Sweden.

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Chapter 21

SWITZERLAND

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I OVERVIEW

With a competitive tax system, stable political environment and skilled workforce, Switzerland is home to a large number of corporations and to important subsidiaries of many large international groups across a broad range of industries. As a result, there is very frequently a Swiss component to lending and secured finance transactions.

The corporate lending market in Switzerland is a well-developed and stable market with experienced participants (banks, borrowers and advisers). Where Swiss borrowers are involved, the market is largely in the hands of banks (Swiss and non-Swiss). On occasion, certain other professional investors (e.g., pension funds and insurance companies) are involved in the corporate lending market in Switzerland. On leveraged finance transactions (especially transactions arranged in the United States but with a Swiss component), it is not uncommon to see specialised lending entities (e.g., debt funds) participate.

Over the past few years, including during the financial crisis, the Swiss corporate lending market has managed to remain stable. It has not had much of a downturn during and after the financial crisis and has seen a low number of distressed borrower situations. Recently, a significant uptrend in acquisition financing transactions could be observed in Switzerland and a high availability of debt generally.

II LEGAL AND REGULATORY DEVELOPMENTS

Regulatory developments have not recently had a major impact on the corporate lending market in Switzerland or on documentation. Increased capital and liquidity requirements did have somewhat of an impact in that the regulatory efforts aimed at reducing the balance sheets of major banks (e.g., the leverage ratio) have the effect of putting a limit on the overall volume of available credit. Also, increased attention is, on occasion, paid to collateral aspects of lending transactions to ensure that the particular transaction can be treated as a secured transaction for regulatory purposes. Other areas that have gained more attention in the context of corporate lending transactions generally are the areas of sanctions and anti-corruption regimes, and the expected discontinuation of LIBOR and other interbank offered rates.
III TAX CONSIDERATIONS

Under Swiss domestic tax laws, interest payments by a Swiss borrower under a bilateral or syndicated financing are, as a rule, not subject to Swiss withholding tax if the Swiss tax law rules commonly referred to as the Swiss non-bank rules are complied with.

These rules address, among other things, a potential tax recharacterisation of a borrowing that is not subject to Swiss withholding tax into a public bond issue that is subject to withholding tax. This Swiss withholding tax law issue is triggered where:

a. a syndicate consists of more than 10 lenders that are not licensed as banks (the 10 non-bank rule);
b. a Swiss obligor has, on an aggregate level (i.e., not on a transaction-specific level), more than 20 creditors that are not licensed as banks (the 20 non-bank rule); or
c. a Swiss obligor has, on an aggregate level (i.e., not on a transaction-specific level), more than 100 creditors that are licensed as banks, under financings that qualify as deposits within the meaning of the relevant rules (the 100 non-bank rule).

A breach of the Swiss non-bank rules can result in the applicability of Swiss withholding tax (currently at a rate of 35 per cent). Such tax would have to be withheld by the Swiss obligor. A standard tax gross-up clause may, in light of a related prohibition in the Swiss Withholding Tax Act, not be valid and enforceable in Switzerland, in particular where the reason for the withholding tax is a breach of any of the Swiss non-bank rules. To tackle this issue, there is, in practice, an attempt to achieve the same commercial result by means of a clause that provides for a recalculation of the applicable rate of interest, rather than the payment of a grossed-up amount, if a tax deduction is triggered. It is untested in courts where such clauses are valid and enforceable.

A particular tax at source applies to payments secured by Swiss real estate when made to non-Swiss lenders, unless exempted under the applicable double taxation treaty.

No stamp or documentary taxes are payable in Switzerland in respect of the execution or delivery of loan and security documentations as a condition to the legality, validity, enforceability or admissibility in evidence thereof in Switzerland. Notary fees and registration duties may be payable with respect to documents that are drawn up as public deeds, or need to be filed with a registry (e.g., security on real estate, title retention).

Where participations in a loan are evidenced by debt recognitions or instruments that are taxable under the Swiss Stamp Tax Act, a transfer thereof made by securities dealers (as defined in the Swiss Stamp Tax Act) as a principal or intermediary are subject to Swiss federal turnover taxes.

Finally, it is common practice in the Swiss market to insert Foreign Account Tax Compliance Act provisions in finance documents. These provisions are typically largely based on the corresponding recommendations published by the Loan Market Association but typically provide for certain changes reflecting market practice in Switzerland.

IV CREDIT SUPPORT AND SUBORDINATION

i Security

Taking a valid and enforceable security interest over assets and rights located in Switzerland or governed by Swiss law typically requires that appropriate security agreements governed by Swiss law be entered into.
As a matter of Swiss conflict of laws rules, the security provider and the secured party are generally free to choose the governing law of the security documents (with certain exceptions). However, Swiss conflict of laws rules typically provide that such a choice of law is not enforceable against third parties, including the creditors of the security provider. Given the importance of enforceability of collateral, it is, therefore, market practice for assets and rights located in Switzerland or governed by Swiss law to put in place Swiss law-governed security documents, providing for jurisdiction in Switzerland.

Swiss law does not allow the taking of a floating charge or 'blanket' security (or similar security concepts), namely the granting of a security interest over all or substantially all assets and rights of the security provider, irrespective of their type or nature. Swiss law provides that, for a security interest to be validly granted, the assets and rights to be covered by the security interest have to be clearly identified or identifiable, and the substantive requirements for each type of asset or right have to be complied with. This is one of the reasons for which it is market practice in Switzerland that separate security documents are prepared for each security asset class and one does not see, in the Swiss market, single security documents in relation to all or various asset classes.

The scope of a Swiss security package is determined on a case-by-case basis and is driven by a number of factors, including what the meaningful assets of the particular security provider or group are. The following asset classes are typically considered: shares, bank accounts, receivables and other contractual rights, real estate, intellectual property rights and, on occasion, tangible movable property.

**Shares**

The creation of a security interest over shares of a Swiss company (either a corporation limited by shares or a limited liability company) takes the form of a pledge. The creation of a valid pledge over shares of a Swiss company requires the parties to enter into a written pledge agreement. There is no requirement for such an agreement to be notarised and it can be entered into in counterparts.

The requirements for creating a share pledge governed by Swiss law depend on whether the shares are certificated or dematerialised. Also, certain special rules apply where shares constitute book-entry securities within the meaning of the Swiss Book-Entry Securities Act.

If the relevant shares are certificated, the creation of the pledge requires that the physical share certificates be delivered to the pledgee or its agent. If the shares are registered shares, the share certificate must be endorsed or assigned (and it is customary to require that the share certificate delivered to the pledgee be endorsed in blank by the pledgor).

If the relevant shares are dematerialised (i.e., not certificated), the perfection of the pledge requires that the pledgee and the bank holding the pledged shares in custody enter into a written control agreement, whereby the bank will act for all practical purposes as pledge holder for the benefit of the pledgee.

Registered shares of Swiss corporations are often subject to share transfer restrictions (i.e., provisions that condition the transfer of title to the shares to the approval of the board of directors of the issuer of the pledged shares). As the board of directors of the issuer may not be cooperative in an enforcement scenario, it is customary for secured lenders to require that any such transfer restrictions be removed prior to the pledge being granted. Eliminating share transfer restrictions requires an amendment to the articles of association, which requires, among other things, a shareholders’ meeting held before a notary public. This process takes some time and it is, therefore, best to address this issue early in the process.
Share pledge agreements typically also contain provisions dealing with the exercise of voting rights and rights to any dividend payments. Typically, the pledgor retains the right to vote the pledged shares as long as no event of default (or similar event) has occurred. Voting rights can then be exercised by the pledgee or its agent upon the occurrence and during the continuance of such an event. With respect to dividend rights, these rights are also typically pledged, but it is customary to provide that the pledgor is entitled to collect dividends as long as no event of default has occurred. It is often also provided that dividend payments are to be made to a pledged account.

**Bank accounts**

The creation of a security interest over a bank account is somewhat a misnomer in that the actual asset on which a security interest is created is the claim of the bank account holder against the bank for any amount standing to the credit of the bank account. Creating a security interest over a bank account can take the form of a pledge or of an assignment for security purposes. Both types of security interests require a written agreement (no notarisation is required), and no other step is legally required for perfecting such a security interest. However, until the account bank is notified of the security interest, it may freely pay any amount due to the account holder or to a designated payee. It is, therefore, customary to notify the account bank of the creation of the security interest with the result that the account bank may then only discharge its payment obligations towards the account holder with the consent of the secured creditor.

Bank accounts held with Swiss account banks are governed by the general terms and conditions of the relevant bank. The general terms and conditions typically provide for a general right of pledge and a right of set-off (and sometimes for certain additional similar rights) in favour of the bank. Unless the general pledge and right of set-off are waived by the account bank, they rank senior to the security interest of the secured lenders. It is, therefore, customary for secured lenders to request that such rights be waived. As banks are often reluctant to waive such rights, it is best to address this issue early in the process, and the compromise is often to seek and obtain a waiver, which carves out claims for reasonable fees of the account bank from the waiver.

**Receivables and other contractual rights**

Creating a security interest over receivables or other contractual rights can take the form of a pledge or of an assignment for security purposes. Both types of security interests require a written agreement (no notarisation is required) and no other step is legally required for creating such a security interest. Same as for a bank account security, the notification of the security interest to the debtor of the receivables is not a requirement for the validity of the security interest, but is advisable to protect the secured lenders. There are two other reasons for which an early notification is in the interest of the secured lenders: without notification, the assigned debtor can (1) validly raise against the assignee any defence or objection (including set-off) it could have raised against the assigned debtor at the time of the assignment notification; and (2) validly set off against the assignee a claim that was not due at the time of the assignment notification, provided the claim did not become due after the assigned claim.

It is, therefore, market practice that the security interest be notified to the assigned debtor, but the timing of the notification depends on the types of receivables or rights.
For trade receivables for which there is often some sensitivity on the part of the security provider to see its clients and customers being notified of a security interest, it is often the case that notification is made upon the occurrence of an event of default only, or upon it otherwise becoming necessary in the discretion of the secured party to protect the security interest. Also, the security provider is often required to grant a security interest over the bank accounts to which payments are made by the assigned debtors.

With respect to intercompany receivables or other rights where there is less sensitivity to immediately disclose the existence of a security interest (such as a security interest over insurance claims), it is customary to provide that the existence of the security interest is notified to the relevant assigned debtor concurrently with the entering into of the security document.

Under Swiss law, it is possible to create a security interest not only in relation to existing receivables but also in relation to future receivables, provided they can be identified upon coming into existence. This requirement is satisfied when such future receivables are identified as arising in the ordinary course of the business of the assignor. However, from a practical standpoint, this designation would be of little use to the secured creditors without a periodic reporting of the grantor of the outstanding receivables, identifying the amount, nature and debtors of the receivables covered by the security interest. Without this information, it may be not be possible for the secured creditors (or their security agent) to notify the security interest to the relevant debtors, or enforce or collect the receivables or rights.

**Tangible movable property**

Creating a security interest over tangible movable property would take the form of a pledge and requires a written pledge agreement (no notarisation is required).

As perfection of the pledge over tangible movable property requires the security provider to transfer possession over the pledged assets to the secured lenders (or their security agent). It is because of this requirement that taking a security interest over operational movable assets (such as inventory, work in progress or industrial tooling) is usually not compatible with operational requirements of the security provider and is therefore an infrequent form of security in Switzerland.

Where the security provider stores tangible movable property with third parties (e.g., an oil refiner storing crude or refined products in storage capacities owned by a storage operator), it may be possible to create a valid security interest over the tangible movable property with the third parties acting as pledge holders.

**Real estate**

In the context of secured lending, taking a security interest over real estate located in Switzerland usually takes the form of a transfer for security purposes of a mortgage note charging the relevant real estate property. Secured lenders should pay attention to restrictions that may affect residential real estate deriving from the Swiss Federal Law on Acquisition of Real Property by Foreigners. Also, as mentioned in Section III, a tax at source may apply to interest payments secured by Swiss real estate when made to non-Swiss lenders (exceptions under applicable double taxation treaties).

**Intellectual property rights**

Creating a security interest over intellectual property rights would take the form of a pledge and requires a written pledge agreement (no notarisation is required). From a Swiss law perspective, no other step is generally required for perfecting such a security interest, bearing
in mind that with respect to registered intellectual property rights (trademark, patents, design rights) the pledge would only become enforceable towards good-faith third parties upon the pledge being registered with the relevant intellectual property register. In practice, such a registration is often a post-closing item.

**Security agent**

It is possible under Swiss law that security is granted to, and held by, an agent, and security documents can be drafted so that it is not necessary to amend them upon a change of the secured parties. Where the security interest is a security assignment or a security transfer, the security agent can act in its own name for the benefit of the secured parties. Where the security interest is a right of pledge, it is necessary that the security agent act as direct representative of the secured parties (i.e., in the name and on behalf of the secured parties). The reason for this is that a Swiss law pledge is accessory in nature, meaning, among other things, that the secured party must be identical to the creditor. This can be achieved by having the security agent act as a direct representative, which is the standard approach in Switzerland when accessory security interests are involved (with exceptions for very specific transactions, where it might be necessary to adopt another approach). An alternative approach would be to create a parallel debt and to secure this parallel debt, as this is done in a number of other jurisdictions. However, the concept of parallel debt remains untested in Switzerland and doctrine is scarce. It is for this reason that the parallel debt concept is not frequently used in Swiss security documents (at least not on a stand-alone basis).

**Guarantees and other forms of credit support**

There are two types of guarantee instruments: the guarantee (Article 111 of the Swiss Code of Obligations) and the suretyship (Article 492 et seq. of the Swiss Code of Obligations).

**Guarantee**

Article 111 of the Swiss Code of Obligations provides that whoever promises to another person the performance by a third person of a certain act is obligated to compensate such person for the financial prejudice arising therefrom if the performance does not occur. Under Swiss law, a guarantee is an undertaking independent of the validity of the guaranteed obligation between the debtor and the creditor; in other words, it constitutes a primary and independent obligation that typically is not subject to any defence or objection that relates to the guaranteed obligation. No specific form is required under Swiss law for a guarantee, although the written form is usual. The indication of the maximum amount guaranteed is not required.

**Suretyship**

A suretyship is an obligation that is accessory in nature. Its validity depends on the validity of the underlying obligation. Therefore, a guaranteed party is only in a position to exercise its rights under a suretyship to the extent the underlying obligation is valid, due and enforceable. As a result, a surety is subject to the defences and objections of the debtor of the underlying obligation. A ‘simple suretyship’ requires that the principal debtor be adjudicated bankrupt or subject to composition proceedings before it can be acted upon. A ‘joint suretyship’ allows
the guaranteed party to act upon default of the debtor under its primary obligation. Formal requirements are required in connection with suretyship agreements, such as that it be made in writing and provide for a maximum amount.

In practice, the form of the guarantee is the dominant form in a corporate lending context. Also, in the context of international secured financing transactions where the facility agreement would often be governed by English or New York law, a guarantee provided by a Swiss guarantor would often also be governed by English or New York law. There is no requirement under Swiss law that the guarantee issued by a Swiss guarantor be governed by Swiss law.

iii Priorities and subordination

The priority of a security interest depends on the types of assets considered:

a. with respect to real estate, the priority results from the entry of the mortgage or mortgage note into the land registry;

b. with respect to certificated shares, the perfection of a security interest is subject to a transfer of possession, so that third parties should not be able to take subsequent security over these assets without the consent of the pledgee; and

c. with respect to trade receivables or other receivables, the order of priority is set by chronological order with the first security interest granted being senior to any security interest granted subsequently.

Where applicable, subordination is typically effected by contractual agreement in an intercreditor agreement. Also, in line with international practice, it is not uncommon to provide for structural subordination in financing transactions with different layers of debt.

V LEGAL RESERVATIONS AND OPINIONS PRACTICE

In the context of group-wide financing transactions and acquisition financing transactions, lenders frequently request that all significant group companies provide guarantees or other security interests.

It is the prevailing view in Switzerland that the provision of upstream guarantees (i.e., guarantees for obligations of direct or indirect shareholders of the guarantor) and cross-stream guarantees (i.e., guarantees for obligations of sister companies of the guarantor) is subject to a number of requirements and restrictions.

Essentially, it is held that these guarantees should be treated as the equivalent of a dividend distribution as far as formal and substantive requirements and limitations are concerned. The key implication of this is that upstream and cross-stream guarantees are, in practice, limited to the amount that the guarantor could distribute to its shareholders as a dividend at the time payment is demanded under the guarantee. This limitation is sometimes referred to as the ‘free equity limitation’. Also, payments under upstream or cross-stream guarantees may be subject to tax implications, including Swiss withholding tax implications.

Downstream guarantees (i.e., guarantees for obligations of subsidiaries of the guarantor) are not typically subject to restrictions. Exceptions are possible under certain circumstances, for instance, if the subsidiary is not a wholly owned subsidiary of the guarantor or if it is in significant financial distress.

The requirements and limitations applicable to upstream and cross-stream guarantees, as referred to above, are also applicable to upstream and cross-stream security interests.
Where, in the context of an acquisition, a Swiss entity (e.g., the target) provides guarantees and security interests for obligations of the acquirer (which will become the parent company of the Swiss target as a result of the acquisition), the Swiss security package would be upstream in nature and thus subject to the various requirements and limitations, including the free equity limitation. Other issues may arise in such transactions, especially where there are minority shareholders at the level of the target.

A number of steps are taken in practice to bolster the validity of an upstream security package and to mitigate, as far as possible, the imperfections of such security packages. The starting point is to make sure that the articles of association of the Swiss entity explicitly permit upstream undertakings. It is also important to ensure that the finance documents and the transactions contemplated thereby are properly approved by the relevant corporate bodies. In addition, finance documents will typically address the free equity limitation and certain Swiss withholding tax law points, and they will also typically provide for certain undertakings and assurances by the security provider to mitigate, as far as possible, the upstream limitations. Furthermore, parties are typically advised, for corporate law and tax law reasons, to compensate the Swiss entity for the granting of the upstream security package by means of a guarantee fee or security fee.

Under Swiss conflict of laws rules, parties have extensive freedom to agree on the law that should govern their loan documentation, along with the pertaining security documentation. With respect to the latter, certain limitations apply as set out under Section IV. Further, parties have flexibility to agree on a foreign jurisdiction with respect to their loan and security documentation. Final decisions for monetary claims of competent foreign courts are recognised in Switzerland on the basis of either a particular treaty law (such as the Lugano Convention) or Swiss international private law, provided that the proceedings leading up to the decision comply with basic principles of fair process (as described under the treaty or Swiss international private law), and the decision as to its substance does not violate Swiss public policy.

Generally, finance parties request legal opinions in international financing transactions, but it is also standard practice for domestic syndicated financing transactions and for certain domestic bilateral financing transactions. Such opinions may be limited to the capacity of a Swiss party to enter into a financing transaction, but often the request for such opinions will be to (also) cover validity and enforceability matters. Tax opinions are frequently requested as well. There are no strict rules as to which counsel renders what opinion. Market practice in Switzerland is that the enforceability opinion is rendered by counsel to the lenders. At times, capacity, due authorisation and execution are carved out from the enforceability opinion and covered in a separate capacity opinion rendered by counsel to the obligors. The addressees of these opinions are the finance parties at signing and with limitations (e.g., primary syndication) persons that become finance parties after signing. Opinions may typically be disclosed, but not be relied upon, where legally required, to regulators or advisers of a finance party, and also to affiliates of a finance party.

VI  LOAN TRADING

In Switzerland, the most common methods of loan trading are assignments of the rights of an existing lender under a particular financing to a new lender (or to another existing lender), and transfers of all rights and obligations of an existing lender under a particular financing to a new lender (or to another existing lender).
Sub-participations and other forms of credit risk exposure transactions are also seen in practice but less frequently.

No institutionalised markets exist in Switzerland for loan trading. The loan trading market in Switzerland is a bilateral market. Also, borrowers very typically have a consent right to any trading transactions in their loans (except in the case of an event of default), meaning that borrowers very typically need to get involved when loans are traded.

Also, in light of the Swiss non-bank rules (see Section III), facility agreements will typically provide for certain restrictions applicable to loan trading transactions (e.g., a limitation on the maximum number of non-bank lenders in the syndicate and restrictions on the types of permissible credit risk exposure transactions). Also, in structured transactions, tax rulings are obtained on occasion.

VII OUTLOOK AND CONCLUSIONS

No legal or regulatory developments are currently pending in Switzerland that are expected to have a material impact on the Swiss lending market or its documentation. The low interest rate environment will likely continue to be a factor that has an impact on the corporate lending market. Also, the debt capital markets have been fairly open for a while and continue to be open, including to issuers that may not have been able to tap the debt capital market in the past.
I  OVERVIEW

Banks play a fundamental role as intermediaries in the financial market by taking deposits and providing lending to utilise the funds from the general public to finance valuable production and other investment activities. According to the statistics of the Financial Supervisory Commission (FSC), the banking industry regulator in Taiwan, as at February 2019 the total amount of loans provided by Taiwanese banks was approximately NT$30.07 trillion, an increase of 5.47 per cent from February 2018. As to the Taiwanese syndicated loan market, the total amount of syndicated loans in Taiwan in 2018 was around NT$1.08 trillion, consisting of 186 syndicated loans, a decrease of 3 per cent from 2017. In March 2019, government-owned or managed local banks still dominated the local syndicated loan market. MEGA International Commercial Bank, the Bank of Taiwan, First Commercial Bank, Taiwan Cooperative Bank and CTBC Bank Co, Ltd, are the top five banks providing syndicated loans in Taiwan. Except for CTBC Bank Co, Ltd, the other four are government-owned or managed local banks.

II  LEGAL AND REGULATORY DEVELOPMENTS

Although banks still have a dominant role in the loan market, developments in technology have seen the peer-to-peer (P2P) lending platform – which provides an online platform for bridging direct lending from non-professional lenders to borrowers of individuals or small businesses – develop as an innovative financial broker. P2P lending, also known as marketplace lending, has become a well-developed or known lending practice in other jurisdictions but is still new to the Taiwanese market.

In the face of this new development, the FSC still has concerns. In April 2016, it issued a press release pointing out that the P2P lending platform may (1) become involved in the deposit-taking business, which is regulated by the Banking Act; (2) engage in usury, which would violate the Criminal Law; (3) violate the Fair Trade Act if the platform makes false or misleading statements to potential lenders and borrowers, such as ‘high profit, low cost and low risk’, which may be deemed as misleading advertising; and (4) breach the Multi-Level Marketing Supervision Act if the P2P lending platform establishes a multilevel mechanism to offer borrowers rewards for recruiting new participants. In addition, personal information leakage may be another key issue in P2P lending. At that time, the FSC was contemplating enacting a law to govern P2P lending in the near future.

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Nonetheless, the FSC subsequently issued another press release in September 2016, showing its positive attitude toward fintech, including P2P lending. The FSC encouraged banks to take advantage of the power of fintech, including P2P lending, and concurrently enhance internal control mechanisms and reduce risks in P2P lending. Pursuant to a ruling issued by the FSC on 13 December 2016, a bank or a financial holding company may invest in P2P lending platforms as part of its operations.

Instead of enacting a law to govern P2P lending, the FSC issued a letter on 7 December 2017 encouraging the banks to cooperate with and assist in P2P lending platforms, including custody of the lending proceeds and check of the borrower’s credit. As the banks have stronger internal control mechanisms, from a policy perspective, the banks are encouraged to play an important role in the development of the P2P lending businesses.

In addition, five P2P lending platform operators co-signed the self-regulatory standards on 10 January 2019, which expressly categorise P2P lending platforms as intermediaries providing services that match lenders with borrowers. Under said self-regulatory standards, a P2P lending platform may not offer any guarantee to the borrower as the P2P lending platform shall not take credit risk.

III  TAX CONSIDERATIONS

i  Gross business receipt tax

Gross business receipts tax rates for entities in the financial industry (banks, insurance companies, investment trusts, securities firms, futures and commercial paper enterprises, etc.) are as follows:

a  2 per cent on the revenues generated from the regulated businesses (such as a bank’s deposit-taking business and a securities firm’s underwriting income), except for banks and insurance companies, whose revenues generated from their core businesses from 1 July 2014 onward will apply the rate of 5 per cent;

b  5 per cent on the revenues generated from non-regulated businesses (such as a bank’s rental income from office leases); and

c  1 per cent on an insurance company’s reinsurance premium income.

ii  Withholding tax

For a foreign lender that is a non-Taiwan resident or a profit-seeking enterprise without a fixed place of business in Taiwan, the withholding tax rate for interest applicable to a corporate borrower is 20 per cent, but for interest earned on short-term commercial papers, securitised instruments, government, corporate or financial institution bonds, or conditional transactions, the withholding tax rate is 15 per cent. Moreover, most tax treaties provide a reduced income tax withholding rate of 10 per cent. Taiwan has signed tax treaties with 32 jurisdictions, namely, Australia, Austria, Belgium, Canada, Denmark, France, Gambia, Germany, Hungary, Indonesia, India, Israel, Italy, Japan, Kiribati, Luxembourg, Macedonia, Malaysia, New Zealand, the Netherlands, Paraguay, Poland, Senegal, Singapore, Slovakia, South Africa, Eswatini, Sweden, Switzerland, Thailand, the United Kingdom and Vietnam.
iii Income tax

Under the Income Tax Act, any interest income that is deemed Taiwan-sourced income is subject to Taiwan income tax in general. Typically, the interest paid by a local borrower to a foreign lender will be deemed Taiwan-sourced income. The following types of income are exempted from income tax:

\[ a \] interest on loans offered to Taiwanese government or legal entities within the territory of Taiwan by foreign governments or international financial institutions for economic development, and interest on the financing facilities offered to their branch offices and domestic financial institutions within Taiwan by foreign financial institutions;

\[ b \] interest on loans extended to legal entities within Taiwan by foreign financial institutions for financing fundamental infrastructure projects under the approval of the Ministry of Finance; and

\[ c \] interest on export loans at favourable interest rates offered to or guaranteed for legal entities within Taiwan by foreign governmental institutions or foreign financial institutions that specialise in offering export loans or guarantees.

Moreover, some of the tax treaties provide an exemption from income tax withholding for interest payments. For example, the Netherlands–Taiwan Tax Treaty provides that the interest paid in respect of a bond, debenture or other similar obligation of a Taiwanese public entity, or of a subdivision or local authority of Taiwan, should be taxed only in the Netherlands.

iv Documentary tax

No notarisation or stamp duty is required for the creation of a security interest over different types of assets such as a:

\[ a \] mortgage over real properties;

\[ b \] chattel mortgage over a movable asset, such as machinery and equipment;

\[ c \] pledge over movable assets or securities, or a pledge over the pledgor’s rights that are transferable, such as the pledgor’s rights to bank accounts, accounts receivable or patents; and

\[ d \] secured assignment of property rights.

v Foreign Account Tax Compliance Act

To prevent US taxpayers who hold financial assets in non-US financial institutions and other offshore accounts from avoiding their tax payment obligations, the Foreign Account Tax Compliance Act (FATCA) generally requires foreign financial institutions to enter into agreements with the Internal Revenue Service (IRS) to identify US accounts, and report certain information about those accounts and investments held by US taxpayers to the IRS on an annual basis. If they fail to enter into such agreements to report US accounts, they will face a 30 per cent withholding charge. In 2014, the FSC announced that Taiwan is recognised by the United States as a jurisdiction having ‘agreement in substance’ status in respect of FATCA. This status allows Taiwanese financial institutions to be exempted from the 30 per cent withholding tax on incomes from the United States.

Taiwan and the United States signed an intergovernmental agreement of FATCA (IGA) on 22 December 2016, and the IGA is pending the review and approval of the Legislative Yuan. After the IGA takes effect, the IRS may request the Taiwanese competent authority to provide detailed information of the recalcitrant accounts.
As to the lending market in Taiwan, lenders recognise that in practice they need to be FATCA-compliant to participate in the lending market. To prevent the residual risk of FATCA withholding being imposed on lenders, the standard FATCA provisions, such as excluding FATCA from the tax gross-up and tax indemnity provisions, are normally provided in the loan agreement. The lending market has typically accepted such provisions, which have become a standard part of the loan agreement.

IV CREDIT SUPPORT AND SUBORDINATION

i Security

Under Taiwan law, different types of assets are subject to different formal requirements for perfection of a security interest created over them. Below is a brief introduction to the formal requirements on the most commonly seen security interests. Taiwanese law does not permit the taking of security over ‘all assets’ of an entity by way of a floating charge. As a general rule, the security provider and the security interest holder should enter into an agreement to identify the specific asset subject to the security interest. A general security agreement that does not identify the specific asset, such as a floating charge, is not enforceable under Taiwan law.

Chattels

The security to be created over machinery or equipment may be a pledge or a chattel mortgage. Both security interests give the security interest holder first priority over the machinery and equipment. To create a pledge, the pledgor and the pledgee have to enter into a written agreement, and the pledgor should deliver the possession of the machinery and equipment to the pledgee, but a registration with the competent authority is not required. To create a chattel mortgage, the mortgagor does not need to deliver the possession thereof to the mortgagee; however, a registration with the competent authority will be necessary for the mortgagee to claim the chattel mortgage against a bona fide third party.

Real properties

A security interest over a real property is taken by way of a mortgage registered with the relevant land registration offices. A security interest over a real property will not be validly created if registration is not duly completed. To create a valid mortgage over land, a building or a plant, the mortgagor and the mortgagee should enter into a written agreement and complete the registration.

Bank accounts

A deposit in a bank account can be pledged by way of a written agreement executed by the depositor and the lender, and a notice of the creation of the pledge served on the account bank. The pledge will only be perfected when a notice has been served on the account bank. Nevertheless, as described above, the concept of a floating charge is not recognised under Taiwanese law. In other words, the pledge covers only the cash in the bank account when the pledge is created and notified to the account bank. The pledge will not cover the cash deposited in the bank account after the account bank is notified of the creation of the pledge. To deal with this issue, the pledgor in practice will be required to periodically confirm with
the account bank and agree on the creation of a pledge over the most current balance in the bank account to ensure that the pledge also covers the cash deposited after the creation of the pledge.

_Receivables_

When a receivable or a contractual right is transferable, security over the receivables or contractual rights is taken normally by way of a secured assignment in favour of the lender. A service of notice of the assignment to the obligor of the receivable or the contractual right is required for perfection. To create a pledge over receivables, the pledgee and the pledgor must enter into a written agreement. In addition, the receivables must be identifiable according to the content of the pledge agreement. Further, the obligor should be notified of the creation of the pledge for the pledgee to be able to claim the pledge against the obligor.

_Shares_

According to the new amendments to the Company Act, a public company should issue share certificates, whereas a private company may determine whether to issue share certificates. In addition, a company issuing share certificates may issue them in scripless form or in certificated form. To create a pledge over shares in certificated form, a written agreement is required. The certificates of the pledged shares shall be duly endorsed and delivered by the pledgor to the pledgee. Furthermore, the company issuing the shares shall be notified of the creation of a pledge to register the pledge on the shareholders’ roster. The creation of a pledge is valid between the pledgee and the pledgor when the certificates of the shares have been endorsed and delivered to the pledgee. Without a notice to the issuing company, the creation of the pledge cannot be claimed against the company.

To create a pledge over listed shares in scripless form, which are traded and transferred through the book-entry system of the Taiwan Depository & Clearing Corporation, the pledgor and the pledgee have to sign a form prescribed by the Taiwan Depository & Clearing Corporation and have the pledge registered with it.

ii  **Guarantees and other forms of credit support**

_Guarantor_

A guarantor may refuse to perform the guaranteed obligations until the compulsory execution against the property of the borrower proves to be futile (i.e., the lender must seek payment from the principal debtor first); provided, however, that the guarantor may waive (and in practice must waive as required by a lender) this defence (i.e., _beneficium ordinis_) in advance. In practice, a guarantor is normally required to act as a joint guarantor (i.e., jointly and severally liable with the borrower for the loan), so the lender may commence concurrent legal action against both the borrower and the guarantor.

If the guarantor is not a joint guarantor or waives the defence of _beneficium ordinis_, the lender must seek payment from the borrower first and the guarantor later. The legal proceeding for the lender to seek payment from the borrower may take months or years. Therefore, there is a risk that before the lender seeks payment from the guarantor, the guarantor may attempt to transfer its assets to others to avoid enforcement by the lender.
**Negative pledge**

In addition to a general negative pledge in the loan agreement, the lender may seek a specific negative pledge from the borrower (that is, a company limited by shares) as provided under the Banking Act. When no collateral is provided to a lender under a financing transaction, the lender may require the board of directors of the borrower to pass a resolution providing a negative pledge undertaking that the borrower will pledge or mortgage its assets in favour of the lender and, before that is done, the borrower shall not pledge or mortgage the same to any third party. If the borrower breaches the undertaking, the borrower’s directors or officers who make the decision to breach the negative pledge shall be jointly and severally liable for compensating the lender, and shall be subject to imprisonment for not more than three years, detention or a criminal fine of not more than NT$1.8 million (or both).

**iii Priorities and subordination**

**General principle**

Security interests, such as a pledge and a mortgage, will have priority over other claims or rights of the borrower’s creditor unless otherwise provided by mandatory provisions of laws. The sale proceeds of the mortgaged or pledged property in a court compulsory execution proceeding will be allocated and distributed in accordance with the following order:

- a expenses paid by the pledgee or the mortgagee for the compulsory execution proceedings;
- b applicable taxes having priority over the security interest under mandatory provisions of laws;
- c statutory security interest;
- d the mortgagee or pledgee of the property;
- e certain labour claims if the employer winds up or liquidates its business or has been adjudicated bankrupt;
- f applicable taxes, if any, having no priority over the security interest; and
- g unsecured creditors.

**Subordination agreement**

In the case of unsecured financing, the lender in practice would require that the borrower enter into a subordination agreement with the borrower’s shareholders or affiliates so that the unsecured loans provided by these persons to the borrower will be subordinate to the loan provided by the lender. Unlike a security interest having priority over unsecured debts of the borrower, the subordination agreement is merely a contractual undertaking from the borrower and its shareholder or affiliate, and does not have the effect of priority preferred by law.

**V LEGAL RESERVATIONS AND OPINIONS PRACTICE**

**i Limitations for foreign companies on taking security**

Regarding the requirements on the legal capacity of foreign companies to take security, in the past, a foreign company that neither had a branch in Taiwan nor was recognised by the Ministry of Economic Affairs in general could not obtain a security interest. Nevertheless, the amendments to the Company Act took effect on 1 November 2018. The above recognition requirement for foreign companies was removed. For now, in general, a foreign company without registering a branch in Taiwan has the same legal capacity as a local company.
response to the amendments to the Company Act, relevant authorities in charge of the registration of security interests are discussing the logistics for accepting a foreign company’s application for registering a security interest.

**ii Limitations on lending and making guarantees**

*Private company*

According to the Company Act, a company shall not lend to any shareholder of the company or any other person except: (1) where an intercompany or interfirm business transaction calls for such a lending arrangement; or (2) where an intercompany or interfirm short-term financing facility is necessary, provided that the amount of the financing facility shall not exceed 40 per cent of the amount of the net value of the lending company. In addition, a company shall not act as a guarantor of any nature, unless otherwise permitted by any law or the articles of incorporation of the company.

*Public company*

In addition to the restriction provided in the Company Act, a public company should adopt internal rules in accordance with the Regulations Governing Loaning of Funds and Making of Endorsements or Guarantees by Public Companies. The internal rules must set forth the rules and guidelines a company should follow in making loans or providing guarantees. For example, a public company may not make endorsements or guarantees for other companies except for (1) a company with which it does business; (2) a company in which the public company directly or indirectly holds more than 50 per cent of the voting shares; or (3) a company that directly or indirectly holds more than 50 per cent of the voting shares in the public company. Moreover, companies in which the public company holds, directly or indirectly, 90 per cent or more of the voting shares may make endorsements or guarantees for each other, and the amount of the endorsements or guarantees may not exceed 10 per cent of the net worth of the public company, provided that this restriction shall not apply to endorsements or guarantees made between companies in which the public company holds, directly or indirectly, 100 per cent of the voting shares.

**iii Financial assistance**

Financial assistance generally refers to assistance provided by a target for the acquisition by a third party of shares in the target, by advancing funds, making loans or providing security. Generally, the provision by the company of financial assistance in this context is subject to restrictions under Taiwan law. As mentioned in subsection ii, there are prohibitions and restrictions regarding the loans or guarantees provided by a company. The provision of security other than a guarantee will generally be deemed as providing a guarantee as well and is subject to the same restrictions.

**iv Choice of a foreign governing law**

Generally, the choice of a foreign governing law to govern a contract (e.g., the loan agreement) would be recognised as a valid choice of law and given effect by the courts of Taiwan, provided that the relevant provisions of the foreign governing law would not be applied to the extent the courts hold that: (1) the application of the provisions would be contrary to the public order or good morals of Taiwan; or (2) the provisions would have the effect of circumventing mandatory or prohibitive provisions of Taiwanese law. However, where the contract is about
the creation or perfection of a security interest, such as a pledge and mortgage, the choice of law will be subject to the law of Taiwan regarding conflicts of law. As a general rule, if the property is located in Taiwan or if the rights subject to the security interest arise from Taiwanese law, such as the shares in a Taiwanese company, the law of Taiwan on conflicts of law will refer to Taiwan law as the governing law.

VI LOAN TRADING

i Performing loans
According to a ruling issued by the FSC, a bank generally shall not transfer its performing loans to others unless it meets any of the following exceptions: (1) it obtains consent from the borrower; (2) it transfers its loan to other financial institutions pursuant to the Financial Institutions Merger Act or the Financial Asset Securitisation Act; or (3) it has a special need to do so, such as for refinancing purposes. If the bank violates the above restrictions, it may be deemed as violating the principle of good faith and according to Article 294(1)(2) of the Civil Code, the transfer may be invalid. Furthermore, the bank may be deemed as violating its confidentiality obligations under the Banking Act.

ii Non-performing loans
According to the Directions Governing the Sale of Non-Performing Loans by the Financial Institutions, in general, financial institutions shall collect the debts themselves; provided however, that a financial institution may sell its non-performing loans when the ratio of the non-performing loans of the financial institution exceeds a certain percentage (currently 3 per cent); or, if less than 3 per cent, the non-performing loans are syndicated loans, loans extended by offshore branches or offshore banking units of the financial institution, or loans extended to construction companies.

VII OUTLOOK AND CONCLUSIONS

Compared with 2017, the syndicated loan market for 2018 was stable with a small increase in the loan proceeds raised. Nevertheless, with the Taiwanese government in full support of developing offshore wind power in Taiwan, it is foreseeable that the need for syndicated loans to finance the offshore wind power projects, either ongoing or planned, would be much stronger in the coming years.

Against the above background, because the P2P lending platform provides a more convenient and efficient channel for lending money and investing, and allows different kinds of borrowers to utilise more flexible lending amounts, it has been strong recently. Furthermore, as the FSC remains open-minded about this emerging channel and encourages the banks to cooperate with and assist in P2P lending platforms to develop the P2P lending businesses, it may have an impact on the traditional financial industry, especially the banks.
I OVERVIEW

Turkey is the 19th largest economy in the world, with a gross domestic product of US$784 billion. Per capita, income in the country is approximately US$9,600.

The banking system traditionally has a majority share in the Turkish financial sector; however, there has been an increase in the number and size of non-bank financial institutions, such as leasing and insurance companies. As at December 2018, of the 52 banks operating in Turkey, 34 are deposit-taking banks, 5 are participation banks and 13 are development banks. Three of these 13 are state-controlled banks and 10 are private banks, including four with foreign capital.

Turkish Banking Law No. 5411 permits deposit-taking banks to engage in all fields of financial activities, including deposit collection, corporate and consumer lending, foreign exchange transactions, capital market activities and securities trading. The main objectives of development and investment banks are to provide medium and long-term funding for investment in different sectors.

Turkish deposit-taking banks (including participation banks) have been the main finance providers to Turkish corporates, where lending has been in the form of revolving lines of credit, acquisition financing, bridge loans, club deals, secured or unsecured term financing, limited recourse project finance, structured and off-balance sheet financing. On selective deals, Turkish banks started to use the terms of the Loan Market Association in financing transactions after adapting relative provisions to mandatory requirements of Turkish law.

Turkey’s banking sector’s gross assets grew by 18.7 per cent in 2018; however, loan demand, which significantly outpaced deposit growth, necessitated policies promoting a higher saving ratio in the economy.

II LEGAL AND REGULATORY DEVELOPMENTS

In the second half of 2018, there were significant regulatory amendments to the lending legislation due to the depreciation and volatility of the Turkish lira, rating downgrades, an

1 Sera Somay is a partner at Paksoy.
2 www.tuik.gov.tr/PreHaberBultenleri.do?id=30886.
4 A new participation bank, Türkiye Emlak Katılım Bankası AŞ, which is 100 per cent owned by the Turkish government, obtained authorisation from the Banking Regulation and Supervision Agency on 26 February 2019.
increasing inflation rate and rising distress in the private sector. To stabilise the market, particularly volatility of the Turkish lira, the Banking Regulation and Supervision Agency (BRSA) and the Central Bank of Turkey have taken certain measures by amending the lending and restructuring regimes.

One of the most dramatic changes is the restriction on the foreign currency loan utilisations of Turkey-resident corporates from banks operating both in and outside Turkey. Pursuant to the new rules, Turkish legal persons are not entitled to utilise foreign-currency indexed loans but they are entitled to utilise foreign currency loans to the extent they fall within the scope of the exceptions listed under Decree No. 32 on the Protection of Value of Turkish Currency. Certain exceptions are briefly as follows: Turkey-resident legal entities generating foreign currency income; foreign currency borrowings of public institutions, banks, financial leasing companies and financing companies; foreign currency borrowings of legal entities with a credit balance of US$15 million or greater and foreign currency borrowings of legal entities with an investment incentive certificate allowing them to borrow in foreign currency.

In addition to the foreign currency borrowing restrictions, the BRSA introduced a new regime for restructuring debt in the Turkish market owed to banks, and financial leasing, factoring and financing companies. Accordingly, restructuring should be made based on a framework agreement that was prepared by the Union of Banks of Turkey, opined by banks, and financial leasing, factoring and financing companies, and approved by the BRSA. The Banks Association of Turkey published a financial restructuring framework agreement on 11 September 2018 (the Framework Agreement) in line with the Regulation on Restructuring of Debts Owed to Financial Sector issued by the BRSA. Accordingly, a debtor (1) with a minimum credit balance of 100 million Turkish lira (including cash and non-cash loans) to Turkish financial institutions at the time of the application, (2) whose indebtedness is classified under Class 1, Class 2 or frozen credit as per the relevant BRSA regulations, and (3) against whom enforcement proceedings (subject to exceptions) have not been initiated by Turkish financial institutions, can apply for a restructuring under the Framework Agreement.

III   TAX CONSIDERATIONS

Loan transactions are subject to various taxes and regulations depending on whether:

- the parties are related parties;
- the lender is a bank or a similar financial institution; or
- the lender is resident in Turkey.

i   Corporate tax considerations

From a corporate tax perspective, interest payments are deductible as long as they are related to the borrowers’ business.

There is an interest deduction limitation, but it is not applicable *de facto* because of the absence of secondary legislation.

ii   Related-party loans

Where the borrower and the lender are related parties, the loan transaction is subject to transfer pricing and thin capitalisation rules.
An arm’s-length interest should be determined according to Turkish transfer pricing regulations. It is very similar to the Organisation for Economic Co-operation and Development legislation, adopting the same principles, definitions and methods.

According to Turkish thin capitalisation rules, a 3:1 debt-to-equity ratio is applicable for related party loans. The ratio is 6:1 if the lender is a bank or similar institution.

### iii Loans from non-bank non-resident companies

**Stamp tax**

Loan agreements and related signed documentation are subject to 0.948 per cent stamp tax. An annually determined ceiling amount is applicable for the maximum stamp tax payable.

**Interest withholding tax**

A 10 per cent interest withholding tax is applicable.

**VAT**

Interest payments are subject to a reverse charge of 18 per cent value added tax (VAT).

**RUSF**

The Resource Utilisation Support Fund (RUSF) is a form of tax imposed on credit-based imports and loans. RUSF will depend on the type of currency and the average maturity of the loan:

a for Turkish lira-denominated loans, the below rates are applicable depending on the average maturity over the interest amount:
- up to one year: 1 per cent; and
- from one year and upwards: zero per cent; and

b for foreign currency-denominated loans, the below rates are applicable depending on the average maturity over the principal amount:
- up to one year: 3 per cent;
- from one to two years: 1 per cent;
- from two to three years: 0.5 per cent; and
- from three years and upwards: zero per cent.

### iv Loans from banks

The taxation of loans from banks varies according to whether the lender bank operates in Turkey.

**Banks operating in Turkey**

The term ‘banks operating in Turkey’ refers to both Turkey-resident banks and Turkish branches of non-resident banks:

a stamp tax: loan agreements and related documentation signed by banks are exempt from stamp tax;

b interest withholding tax: no interest withholding tax is applicable;

c RUSF: as long as the loan is not a consumer loan, zero per cent RUSF should be applicable;
VAT: interest payments should be exempt from VAT; and
banking and insurance transaction tax (BITT): the interest income derived is subject to 5 per cent BITT.

**Banks operating outside Turkey**

The term ‘banks operating outside Turkey’ refers to both non-resident banks and foreign branches of Turkey-resident banks:

- **a** stamp tax: loan agreements and related documentation signed by banks are exempt from stamp tax;
- **b** interest withholding tax: zero per cent interest withholding tax is applicable;
- **c** VAT: interest payments should be exempt from VAT;
- **d** BITT: no BITT should be applicable;
- **e** RUSF: RUSF will depend on the type of the currency and the average maturity of the loan;
- **f** for Turkish lira-denominated loans, the below rates are applicable depending on the average maturity over the interest amount:
  - up to one year: 1 per cent; and
  - from one year and upwards: zero per cent; and
- **g** for foreign currency-denominated loans, the below rates are applicable depending on the average maturity over the principal amount:
  - up to one year: 3 per cent;
  - from one to two years: 1 per cent;
  - from two to three years: 0.5 per cent; and
  - from three years and upwards: zero per cent.

Separately, the RUSF rate applicable for financing provided to Turkish banks is always zero per cent, regardless of the average maturity.

IV  CREDIT SUPPORT AND SUBORDINATION

### Securities

In general, the following types of security interests would be available for project financing:

- **a** pledges:
  - over movables;
  - over shares; and
  - over bank accounts;
- **b** mortgages;
- **c** transfer or assignment of receivables; and
- **d** guarantees and suretyships (which are summarised later on in this section).

### Pledges

In principle, the conditions below should be met for the establishment of a pledge under Turkish law:

- **a** secured receivable: there must be an existing underlying right, loan or debt prior to or at the time of the establishment of the pledge;
- **b** pledge over movables: the pledge should be registered within the registry of the pledge over the movables; and
- **c** written agreement: a written pledge agreement must be executed between the parties.
Movable pledges

A new law aiming to facilitate the use of a movable asset pledge with regard to commercial operations entered into force on 1 January 2017 (the Movable Asset Pledge Law) along with three regulations regarding procedures under the Movable Asset Pledge Law.

The Movable Asset Pledge Law and these regulations broaden the scope of the assets that can be the subject of a movable pledge, introduce a central registration system as opposed to the previous system, which was based on physical delivery of the assets, and introduce alternative enforcement methods.

ii Scope of pledges

Pledges over movables

The scope of the commercial enterprise pledge is now extended and includes real property allocated to the operations of an enterprise as well as all the movables (including tangible and intangible assets).

Regarding a pledge on assets on an individual basis or as a group, the previous pledge system required the physical delivery of the pledged assets to the pledgee and this was one of the reasons why the commercial enterprise pledge (which didn't require physical delivery of the pledge assets) was commonly used in Turkey. The Movable Asset Pledge Law does not require the physical delivery of the pledged asset to the pledgee. The following assets are subject to this law:

a. existing and future receivables, income of the enterprise;

b. inventory, raw materials;

c. rental proceeds, rental rights;

d. IP rights, trade name;

e. licences that are not qualified as administrative approvals;

f. all movable assets of an enterprise such as machinery, equipment, IT hardware, etc;

g. agricultural products, livestock;

h. commercial projects;

i. vehicles, licence plates;

j. commercial routes, train wagons; and

k. revenues of the pledged assets.

A pledge of the following assets is not subject the Movable Asset Pledge Law and should be regulated by the Civil Code or by its special laws:

a. bank accounts;

b. shares;

c. derivative agreements;

d. aircraft;

e. ships or vessels; and

f. mines.

It is also still possible to pledge vehicles under their specific traffic laws.

Pledges over shares of a company

The shares of a company can be pledged under Turkish law. The scope of the share pledge can be commercially agreed between the parties.
A pledge over the shares of a company can only be established by entering into a written share pledge agreement by and between the pledgor and the pledgee. In addition, the pledgor should make a pledge endorsement (or blank endorsement depending on the agreement between the parties) on registered shares, and physical possession of the pledged shares must be delivered to the pledgee.

Although it is not legally required for a valid perfection of share pledge, it is advisable (to protect the pledge from third-party claims) that:

a the company whose shares are pledged passes a corporate resolution acknowledging the pledge and resolving to register it in the share ledger of the company; and

b the pledge is registered in the share ledger of the company in which the shares are pledged.

**Pledges over bank accounts**

A pledge over accounts held with a bank is another form of security arrangement that is generally provided under Turkish law.

A written pledge agreement is required for the establishment of a bank account pledge. There is no requirement for a pledgor to obtain consent from the account holding bank for the pledge in favour of the creditor. However, an acknowledgment notice from the bank is highly recommended, particularly if the account bank is not a lender or a security agent, and any obligations (e.g., restricting withdrawals on paying funds direct to the creditor) are to be assumed by the bank. In addition, the same acknowledgment would serve to confirm that no prior ranking pledge, assignment or counterclaims exist.

**Mortgages**

**In general**

A mortgage can be established over immovable property or certain rights connected to the immovable property, such as a ground lease or usufruct right, to secure the payment of existing or future debts. In general, a mortgage established over immovable property covers the accessories of that property.

**Conditions for establishment**

A mortgage is created validly by means of an official mortgage deed, which shall be executed before the title deed registry having jurisdiction on the relevant real estate. The mortgage is recorded within a special mortgage column on the relevant page of the title deed registry where the records of the real property subject to mortgage are kept.

In principle, the amount of the mortgage must be registered, and if the amount of the receivable is indeterminable, the maximum amount secured by the mortgage agreed by the parties can be registered in Turkish lira. However, an exception for foreign loans provided by Turkish or foreign banks or credit institutions is stipulated under Turkish law as a 'foreign currency mortgage', which should be in the same currency as the loan, and can be granted for establishing a security in favour of these banks or credit institutions.

**Ranking**

The degree system adopted under Turkish law provides a priority ranking to mortgagees holding a mortgage with a higher degree over other mortgagees in subsequent rankings. Each
degree of mortgage on the immovable property separately secures the obligations for which they are established up to the mortgage amount in those degrees. The degrees set the order of distribution of the foreclosure proceeds.

Transfer or assignment of receivables

Transfer or assignment of receivables is commonly utilised as a security mechanism, which includes the transfer of the receivables of the creditor (transferor) to a third person (the transferee) by execution of a written agreement.

In the case of a transfer of receivables by way of security, the following mechanisms are seen: (1) lenders collect the assigned receivables for repayment purposes; (2) the assigned receivables are collected into a reserve account for repayment or security purposes, and (3) the assignment is silent until an event of default, hence it is not perfected and the lender has the right to collect the receivables upon an event of default.

Present and future determinable receivables can be transferred through a written agreement executed between the transferor and transferee.

Although notification or approval of the debtor is not required for the perfection of the transfer, it is recommended that the transfer of receivables agreement includes a provision obliging the transferor to notify its debtors of the transfer and to request an acknowledgment of no prior ranking assignments, transfers or counterclaims from such debtors.

iii Guarantees and other forms of credit support

Guarantees

Since there is no specific legislation with regard to guarantee agreements, these agreements are subject to the general provisions of the Turkish Code of Obligations No. 6098, dated 11 January 2011 (TCO) regarding the concept of ‘undertaking of performance of a third party’ whereby the obligation of the guarantor is characterised by its independent nature.

Since the obligation of a guarantor is independent from the primary obligation, the invalidity or unenforceability of the primary obligation does not have any effect on the validity or the enforceability of the guarantee obligation. Therefore, unless otherwise agreed, a guarantee is effective until the risk ceases to exist.

There is no condition for the establishment of a guarantee (other than a personal guarantee) such as a written agreement or requirement to determine a limit or cap for the guarantee. However, according to the TCO, in the case of a guarantee provided by a real person (personal guarantee), the conditions for a suretyship will be applicable for the establishment of a personal guarantee.

Suretyships

Although a suretyship appears to be similar to a guarantee agreement, the security obligation of the surety depends on the validity of the debtor’s debt. This is to say that when a debtor’s debt becomes invalid for any reason, the surety is – contrary to a guarantee agreement – entirely released of all its obligations. Accordingly, a surety’s liability is always ancillary in nature.

According to the TCO, a written agreement is required between the parties and a statement of the amount of maximum liability agreed in handwritten form by the surety should be provided under the agreement.

In addition, the suretyship period for real persons and the type of suretyship, for example, ordinary or several, should be specified under the agreement. Also, if a married
individual is the surety, the TCO requires the spouse of the surety to provide consent on or before the date of the surety agreement, except for in certain cases. The consent of the spouse is not required for securities that are given as follows:

- for a business or company by the owner of a commercial enterprise registered with the trade registry or the shareholder or manager of a commercial company;
- by craftsmen and artisans registered with the craftsmen’s associations related to the occupational activity;
- for credits used under Law No. 5570, dated 27 December 2006; or
- for credits given by credit and security cooperatives, or credits extended by state institutions and organisations to cooperative partners.

Finally, the TCO provides that if the surety is a real person, the suretyship automatically expires at the end of a 10-year period beginning from the execution of the surety agreement. However, the parties may extend the suretyship for an additional 10 years upon the consent of the surety, which may be obtained at the earliest one year before the expiration of the surety agreement.

**Quasi-securities**

**Step-in**

In recent years, common quasi-securities in the foreign lending markets have been introduced to the Turkish markets, especially for energy and infrastructure project financing transactions. One of the most important features in this regard is the step-in provision that gives lenders and banks the right to step into the project company’s rights and obligations under the project documents.

In principle, the Turkish energy markets (electricity, petroleum, gas and liquefied petroleum gas) are strictly regulated and restrict the transfer of licences. However, starting with the first amendment to the electricity markets licence regulation in 2008, banks and financial institutions that provide limited or irrevocable project financing to the relevant generation licence holder within the scope of their loan agreements are also entitled to apply to the Energy Market Regulatory Authority to grant a new licence to another third party, provided that the third party agrees to take on all of the obligations arising under the relevant licence. The legal entity proposed by the banks or institutions shall be granted the related licence on the condition that it complies with the obligations under the relevant licensing regulations. There is no time restriction with respect to the transfer of licences under these regulations, such as prohibition of transfer during or after the construction or operation phase.

However, direct agreements – the objective of which is basically to enable the banks to ‘step into the shoes of the project company’ if it defaults in its loan obligations – are also common on the Turkish markets but only provide a contractual obligation, which may not be enforced before the regulatory or governmental authorities unless it is drafted in compliance with the above-mentioned energy regulations.

**Protection under constitutional documents**

Lenders or banks (through a security agent) may also acquire one single privileged share of a project company (and parent company, if necessary) to control the powers and entitlements at the corporate level and prevent certain resolutions to be taken by the company that may jeopardise the lenders’ rights in the finance documents. For example, a provision stating that
no security may be granted over any of the company assets and no disposal of shares in the project company, or no subordinated debt lent to the company, can be made without the vote of the single privileged share in the company.

**Completion guarantees**

Completion guarantees provided by the parent companies of the project companies are also used as a quasi-security on the Turkish lending markets. In most of the project finance transactions, lenders or banks require a completion guarantee in which the parent company undertakes relevant equity contribution to the project company, the cost overrun of the project and other financial covenants in the facility agreement such as the debt service coverage ratio.

**Negative pledge clauses**

Unlike certain continental law jurisdictions where negative pledge provisions are registered with the registrar of companies, negative pledge covenants, binding upon the parties, only constitute contractual undertakings under Turkish law, and specific performance cannot be imposed on the pledgor breaching such a covenant. Pursuant to the applicable legislation, such restrictive clauses cannot be agreed under movable pledge or mortgage agreements. Still, these provisions are commonly used in the Turkish lending markets. In the case of a breach of such a covenant, the claimant may request damages or, in certain exceptional circumstances, file for the cancellation of the transaction.

iv **Priorities and subordination**

**Subordination**

Although subordination is valid as a contractual undertaking and the parties have contractual claims against each other if the provisions of the subordination agreement are not honoured, Turkish law does not recognise subordination of debts in the event of the bankruptcy or insolvency of a Turkish company. Accordingly, in the event of the insolvency or bankruptcy of a Turkish company, subordination will not be upheld by the liquidators and, as a result, the claims of the subordinated creditors will rank *pari passu* with the claims of all unsecured creditors.

In practice, to give effect to subordination arrangements, the lenders request the subordinated creditors to assign or transfer all their subordinated loans – including the receivables to arise in relation to loans to be granted in the future (most commonly shareholder loans) – to them through an assignment or transfer of future receivables.

**Pledged and non-pledged claims, and priorities in the ranking system**

According to the Enforcement and Bankruptcy Law No. 2004, published in the Official Gazette, dated 19 June 1932, receivables of secured creditors have priority over the sale proceeds of secured assets after deduction of the relevant taxes *in rem* (i.e., taxes arising from the use or mere existence of the secured assets such as real estate taxes, motor vehicle taxes and custom duties), and expenses arising from the administration or preservation of the secured assets, or from sale auctions in the case of the bankruptcy of the debtor. In other words, if the debtor goes bankrupt, the pledged assets will be sold and the sale proceeds will be paid to the creditor whose receivables are secured through the pledged asset.
V LEGAL RESERVATIONS AND OPINIONS PRACTICE

A legal opinion in lending transactions can be requested from both parties’ (i.e., lender’s or borrower’s) legal counsel and it is generally referred to the lenders, including the potential assignees or transferees of the loan in the future.

i Reservations

Other than the common reservations that are used in most legal opinions of foreign lending transactions, some of the specific reservations that a Turkish lawyer should cover in a legal opinion are briefly explained below.

Enforceability

The term ‘enforceable’ is generally explained in the reservation section of the legal opinion, providing that enforceability may be limited to certain obligations of the parties, namely:

a bankruptcy, insolvency, liquidation, debt restructuring, reorganisation and other laws of general application relating to or affecting the rights of creditors;

b general principles of law, including, without limitation, concepts of good faith, fair dealing and reasonableness; and

c remedies available before Turkish courts.

In addition, where obligations are to be performed in a jurisdiction outside Turkey, they may not be enforceable in Turkey to the extent that their performance would be illegal under the laws of that jurisdiction.

Interest

To the extent that the application of the provisions of opinion documents relating to interest and default interest results in accrual of interest on default interest, this would not be enforceable under Turkish law on public policy grounds, but the remaining provisions of the opinion documents would continue to be effective.

Security agent concept

Although some court precedents exist that recognise the concept of an owner in trust in respect of immovable property – and in certain financing deals, a security agent was named and registered as the security right holder – the concept of a security trustee or security agent cannot yet be regarded as officially recognised under Turkish law because of the lack of court precedents. To the author’s knowledge, there has been no test of the concept of a security agent before Turkish courts. However, the concept has been commonly used in major financing deals in Turkey, and in the author’s view there would be no reason under Turkish law not to give effect to it.

Use of Turkish language

The Compulsory Use of Turkish Language Law No. 805, dated 10 April 1926, requires all agreements by Turkish parties to be made in Turkish. The prevailing interpretation of this rule in the market based on at least one court precedent is that this requirement does not extend to agreements between Turkish and foreign parties and, therefore, agreements
between Turkish and foreign parties can be signed in a foreign language. However, there are conflicting decisions concluding on the invalidity of an arbitration clause executed in foreign language with a foreign party.

**Notices under the Turkish Commercial Code**

Pursuant to Article 18(3) of the Turkish Commercial Code (TCC), for evidentiary purposes, notices relating to default, termination or rescission should be served through a Turkish notary public, by telegram or by registered mail (return receipt requested), or electronic mail using a secure electronic signature.

Also, under the Compulsory Use of Turkish Language Law No. 805, any notice to be sent to a Turkish borrower must be in Turkish. Although this law is outdated, it is still in force and, accordingly, it would be advisable to send the Turkish translation along with any foreign language notices.

**ii Choice of foreign law**

Under Turkish law, the parties to a contract can freely determine the law applicable to their contractual relationship if the contract includes a foreign element.

**iii Enforcement of judgments**

Judgments obtained in a foreign jurisdiction are enforceable in the courts of Turkey, and courts shall not make any re-examination on the merits of the case provided that the following conditions are met:

- the judgment has become final and binding with no recourse for appeal or similar revision process under the jurisdiction where the judgment is obtained;
- there is *de facto* or *de jure* reciprocity of the enforcement of judgments between the courts of Turkey and the jurisdiction where the judgment is obtained. Reciprocity is to be evidenced by:
  - a treaty between Turkey and the jurisdiction where the judgment is obtained, providing for reciprocal enforcement of court judgments;
  - a provision in the laws of the jurisdiction where the judgment is obtained permitting the enforcement in that country of judgments rendered by Turkish courts; or
  - *de facto* enforcement of judgments rendered by Turkish courts in the jurisdiction where the judgment is obtained;
- the subject matter of the judgment does not fall under the exclusive jurisdiction of the Turkish courts;
- the judgment is not rendered by a court that does not have an actual connection to the parties or the subject matter of the judgment (provided that this is asserted by the defendant);
- the judgment is not explicitly against Turkish public policy (a Turkish court would determine at its discretion, and on a case-by-case basis, whether a public policy concern exists); and
- due process is observed under the jurisdiction where the judgment is obtained.
iv Financial assistance

Prior to the entry into force of the TCC (1 July 2012), there was no specific rule or restriction relating to the use of a target company’s assets for securing the financing of an acquisition (financial assistance) of the target company in Turkey. It was generally accepted that if the articles of the target company enable the issuance of collateral (e.g., pledges, guarantees, sureties) in favour of third parties, the target company may grant security to secure the debts and liabilities of third parties, including its parents or subsidiaries (purchasers).

Following the entry into force of the TCC, financial assistance was introduced with certain limitations (i.e., the granting of security in favour of a third party to acquire its own shares).

These restrictions are mainly based on the prohibition of advancing funds, making loans, and providing security and guarantees by a target company for the acquisition of its own shares. However, there are two exceptions to this prohibition:

a transactions performed by banks or financial institutions, provided that these transactions are performed pursuant to their normal course of business; and

b advances, loans and securities provided to the company’s employees or parent or sister company’s employees to acquire the shares of the company.

The financial assistance rules in the TCC also apply to group companies (i.e., companies formed into groups consisting of a holding company or parent company that owns a number of subsidiaries).

VI LOAN TRADING

The transfer of loans by lenders is permitted via a transfer of agreement, a transfer or an assignment of rights, or by way of novation.

For the transfer or assignment of rights that need to be in writing (see Section IV.i), there may be a requirement in the loan agreement for the existing lender to consult with the borrower or to notify the borrower prior to transferring the loan. Accordingly, the borrower’s consent is not legally required under Turkish law. However, if the borrower is not notified, the borrower’s payments that have been made to the transferor (assignor) in good faith shall be an effective payment.

The transfer of an agreement (loan agreement) is another option for the transferor (exiting lender), remaining party (remaining lenders) and transferee (new lender), whereby a tripartite agreement, which shall be made in the same form as the original (transferred) agreement, is entered into between the transferor, transferee and the remaining party of the agreement, and the transferor cedes its title of party to the agreement together with all its rights and obligations to the transferee.

Neither the transfer of a loan agreement nor the transfer or assignment of a loan would result in termination of the original debt. Therefore, from a Turkish law perspective, the security rights attached to the original debt would not be extinguished following these assignments or transfers.

However, transfer of a loan by way of novation (i.e., the discharge of the original debt) will have the effect of extinguishing the Turkish law-governed security. In such cases, there is a requirement to re-establish the security for the new lender. A parallel debt structure may be a way of preventing the fall of the accessory security as a result of novation. For further explanations of parallel debt, see Section VII.
The transfer of debts (in a loan agreement) is also possible and made by an agreement between the transferor (assignor), the transferee (assignee) and the debtor (borrower). The agreement does not have to be in writing. However, security providers for such debts should provide their consent in written form as well.

There are no registration requirements with the Turkish authorities for a transfer or assignment to be effective.

VII OTHER ISSUES

i Security agent concept

It is widely accepted that security agent provisions are enforceable under Turkish law under the general provisions of law. To date, there have been numerous English law-governed transactions accompanied by Turkish law security documents where the security is held by a security agent or trustee. However, none of those transactions have been tested before the courts in Turkey in respect of the security agent provisions. Therefore, there is no relevant court precedent on the subject.

Nevertheless, it is believed that:

a security interest to be taken in relation to a debt may be validly granted to an indirect agent (i.e., the security agent, acting in its own name, on behalf of and for the benefit of the secured parties or lenders); and

b if the security agent arrangement is recognised by English courts, it is likely that a Turkish court would uphold it as being valid as well.

There are some Turkish court precedents that recognise the concept of an owner in trust (i.e., fiduciary transactions) in respect of movable or immovable property, and there are also certain financing deals on Turkish markets where a security agent or trustee is named and registered as the security right holder acting in the name of and on behalf of the secured parties.

Parallel debt

In other continental law jurisdictions where this issue is also a matter of concern, the concept of parallel debt has been introduced to ensure that accessory security would not fall away as a result of a transfer by novation, and thus enable a changing class of beneficiaries to take benefit of security without the need to have a separate transfer arrangement. Under the parallel debt structure, the security agent has an independent right to demand payment of the parallel debt. The lenders are not, however, entitled to recover the debt twice. Any payment of the outstanding debt by the borrower to a lender will reduce the amount owed to the security agent pro rata (and vice versa with regard to any payment made to the security agent). The security documents will secure the debt owed to the lenders and the parallel debt owed to the security agent. As a result, even if a loan (any portion thereof) is transferred to a new lender by way of novation, the security would remain in place as it would continue to secure the parallel debt. It is believed that this parallel debt structure, which is abstract in nature, would be recognised under Turkish law. However, some scholars argue that there might be enforceability problems where the security agent is not one of the lenders.

ii Private sale

Principles or procedures for enforcing a share pledge through private sale are not regulated under Turkish law. This is a concept accepted in the doctrine. Private sale is considered
within the context of an upfront contractual agreement between the pledgor and the pledgee whereby the pledgee is given the right in the relevant security agreement to enforce the security and cause the pledged collateral to be sold privately.

In a private sale arrangement, the pledgee’s right to enforce the security will be carried out privately and outside the jurisdiction of the execution offices, avoiding the relatively lengthy and costly process of a public sale.

VIII OUTLOOK AND CONCLUSIONS

Although private sector loans are increasing, the volume is still relatively lower than that in developed countries, suggesting that there is much room for financial deepening. However, there are structural obstacles to financial deepening, such as domestic savings, which are still low, and therefore Turkey’s economic growth and corporate lending rely on capital inflows, particularly external financing, to finance investments and growth.

A weak outlook for current global activity and more severe international funding strains have the potential to spill over to Turkey, which may affect the financing required by corporates. Also, as investors have become wary and many emerging markets that rely heavily on foreign investors have seen financial capital being drawn away from their economies, it is still an open question as to how Turkey, with its current account deficit, will be affected by normalisation of monetary policy in advanced economies.

Apart from this global view, there are more Islamic transactions based on commodity *murabahah* and cost-plus financing transactions on the markets. Refinancing and syndicated loans are also becoming more popular in Turkey.
Chapter 24

UNITED STATES

Monica K Thurmond¹

I OVERVIEW

The current US corporate lending market is sophisticated, extremely large and highly varied, having numerous types of borrowers, loan products and lenders. According to Thomson Reuters LPC, leveraged loans to corporate borrowers in the United States accounted for approximately US$1.2 trillion in 2018, a reduction from 2017, but still the second highest year on record. Borrowers span every industry, and the loan markets they can access depends in large part on their capitalisation and credit profile. Loan products span from unsecured revolving credit facilities for investment-grade companies and widely syndicated covenant-lite term loan facilities for large-cap leveraged loan borrowers to more traditional ‘club deal’ senior secured credit facilities for middle-market borrowers (generally defined as borrowers with less than US$500 million in annual sales or less than US$50 million in earnings before interest, taxes, depreciation and amortisation (EBITDA)). Lenders include traditional banks, finance companies and institutional investors such as collateralised loan obligations (CLOs), hedge funds, loan participation funds, pension funds, mutual funds and insurance companies.

In general, loan issuance volume has remained high in recent years, although there has also been increased volatility. According to the twice annual Financial Stability Report, issued in May 2019, of the Federal Reserve (the Fed) the share of new, large leveraged loans going to companies with poorer credit profiles or that already have elevated levels of debt, now exceeds peak levels reached previously in 2007 and 2014. Although the Fed acknowledges that default rates on these loans have remained low, it has warned that ‘any weakening of economic activity could boost default rates and lead to credit-related contractions to employment and investment among these businesses.’ The US loan market has also experienced an expansion; in part due to a recent relaxation of a number of US banking regulations – in particular, the leveraged lending guidelines issued by federal regulators in March 2013, which were further clarified in November 2014 by a FAQ issued on the guidance and had previously had a strong influence on the loan markets, have been significantly curtailed, as discussed in more detail below. Additional developments over the past year had the effect of easing certain components of the risk retention rules and the Volcker Rule.

Leveraged loan issuance levels related to mergers and acquisitions (M&A) increased significantly during 2018 despite an overall decline during that same period. Thomson Reuters LPC noted that leveraged loan issuances related to M&A jumped by 22 per cent in 2018, and leveraged buyout (LBO) activity (which accounted for approximately 40 per cent

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of all M&A loan issuances in 2018) was up 21 per cent from 2016. Thomson Reuters LPC also reports a significant shift in the market from refinancing activity, which declined by 37 per cent in 2017, to new money loans, which increased by 12 per cent.

The US leveraged loan market remains relatively favourable for borrowers, in a multi-year trend that has persisted since the recovery from the financial crisis. For example, the market share of covenant-lite loans, which depends on incurrence-based covenants rather than maintenance covenants, has been increasing consistently since the hiatus during the financial crisis. Other borrower-favourable terms that remain prevalent in the US leveraged loan market include soft-call prepayment premiums, the ability to incur refinancing facilities, the ability to buy back loans in the market on a non-pro rata basis, covenant baskets that can grow over time based upon a percentage of adjusted EBITDA or consolidated total assets, and loosened collateral requirements. In addition, many borrowers, especially those owned by large financial sponsors, have continued to take the lead in drafting loan commitments and definitive loan documentation, and have obtained committed covenant levels and baskets at the commitment stage.

II  LEGAL AND REGULATORY DEVELOPMENTS

From the aftermath of the 2007 financial crisis until recently, federal regulators had increased their focus on the US corporate lending market, and leveraged lending in particular (though it appears that this trend may be starting to reverse in the current US regulatory climate). In March 2013, federal regulators issued new leveraged lending guidelines to address concerns that lenders’ underwriting practices did not adequately address risks in leveraged lending with appropriate allowances for losses. These guidelines apply to federally supervised financial institutions that are substantively engaged in leveraged lending activities. Compliance with the guidelines was required by May 2013, but the full force of their impact only started being felt by the market in 2014, particularly in the fourth quarter. In November 2014, regulators released an FAQ on the guidance, and in their Shared National Credit Report issued the same month, they chastised lenders for non-compliance. Most of the attention concerning federal guidance is focused on their assertion that ‘a leverage level . . . in excess of 6x Total Debt/EBITDA raises concerns for most industries’. In addition to contributing to sharp reductions in lending activity in certain segments of the market, this guidance had an effect on the average debt-to-EBITDA levels, which had consistently climbed in the years leading up to 2014 before dropping and flattening out near the 6 times mark in 2016 for broadly syndicated LBO transactions, according to Thomson Reuters LPC. In February 2018, these guidelines were declared by the chair of the Fed and the head of the Comptroller of the Currency not to be legally binding on federally supervised financial institutions that are substantively engaged in leveraged lending activities. For the fourth quarter of 2018, the average debt-to-EBITDA level for broadly syndicated LBO transactions was 6.4 times.

In December 2013, the final Volcker Rule was issued, which limits the number of trading and investment activities of banking entities. Banking entities will also be required to comply with extensive reporting requirements in respect of permitted trading and investment activities. The Volcker Rule compliance period began in July 2017, and the reporting requirements became effective in June 2014. In December 2016, risk retention rules that were made applicable to CLOs came into effect, initially casting a large shadow over the leveraged loan market (given that CLOs are a prominent source of capital for leveraged lending transactions), but a federal court decision in February 2018 invalidated the rules.
insofar as they apply to open-market CLOs. Also in 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act was enacted and exempted smaller institutions, and regulators have also proposed for comment changes to the Volcker Rule that appear to have the intended effect of simplifying and removing certain compliance burdens while keeping the overall purpose of the rule intact.

Federal regulators have also continued to enforce sanctions and anti-corruption and anti-terrorism laws, and have recently reinvigorated their efforts. As a result, and in response to ever-increasing fines for violations, lenders have expanded the compliance terms included in credit documentation. These efforts have included broader representations and warranties with fewer materiality and knowledge qualifiers, as well as affirmative and negative covenants that require compliance with sanctions regulations and anti-bribery laws, and restrict borrower activities in restricted countries or with restricted entities to the extent that such activities would involve loan proceeds.

US banks also continue to address the Basel III requirements. Basel III requires banks to meet a number of capital requirements to strengthen a bank’s liquidity and contain its leverage. Among other things, Basel III requires banks to increase their holdings of Tier 1 capital to at least 7 per cent of their risk-weighted assets to meet additional liquidity and capital requirements. In December 2014, the Fed proposed that the eight largest US banks should comply with capital requirements that are even more restrictive than those outlined by Basel III, including an additional capital cushion. According to the Fed, most of the firms should already meet the new requirements, and all are taking steps to meet them by the end of a phase-in period that runs from 2016 to 2019.

III TAX CONSIDERATIONS

The US corporate lending market is subject to various federal tax considerations, most of which can be addressed with careful planning and drafting.

i Tax considerations applicable to US borrowers

The initial determination in any US corporate lending transaction will be whether the debt will be respected as debt for federal income tax purposes or characterised as equity. Interest on debt is generally deductible by the borrower (subject to an overall limit that interest deductions may not exceed 30 per cent of a payor’s taxable income (determined without taking into account interest expense and subject to certain other adjustments)), whereas dividends are not. Debt terms that raise the question of whether it may be characterised as equity include a long term to maturity (e.g., in excess of 30 years), subordination to other instruments in the capital structure, a high debt-to-equity ratio at the borrower and, in some circumstances, the right to convert into the stock of the borrower.

Another determination to be made is whether the debt will be treated as giving rise to ‘phantom interest’ that must be taken into account by the borrower and lender even when no payments are made. In general, a debt instrument sold with the original issue discount will result in unstated interest equal to the difference between the issue price and the stated redemption price at maturity, and that interest will be taxed on an economic accrual basis pursuant to the original issue discount (OID) rules. The OID rules also apply to payment-in-kind and similar instruments. The OID rules will not apply if the original issue discount is less than a statutorily defined de minimis amount.
Borrowers subject to US tax laws must also be careful to address the applicable high-yield discount obligation (AHYDO) rules, which substantially restrict interest deductions for debt characterised as an AHYDO. An AHYDO is any debt instrument with a term of more than five years, having a yield that exceeds the applicable federal rate at the time of its issuance by five percentage points or more, and that has ‘significant original issue discount’. Debt will have significant OID if, at the end of any accrual period ending after the fifth anniversary of its issuance, the aggregate amount of interest and discount required to be included in income by a holder exceeds the amount of interest and discount actually paid in cash by more than one year’s yield on the instrument. AHYDO rules may be avoided by incorporating a savings clause in the loan documentation that requires the borrower to pay the minimum amount of principal plus accrued interest on the loan necessary to prevent the deduction of any of the accrued and unpaid interest and OID from being disallowed or deferred.

US companies are generally not required to pay US taxes on the earnings of non-US subsidiaries, including upon the actual distributions of the earnings. The provision of a guarantee or the pledge of assets by a non-US subsidiary to support the loan obligations of a US parent until very recently, however, would often have resulted in an inclusion in gross income for the US parent of an amount of earnings of the non-US subsidy up to the amount of the credit support. In addition, a pledge by the US parent of two-thirds or more of the voting stock of a non-US subsidiary is considered tantamount to a pledge of that subsidiary’s assets, and would therefore have been subject to the same rules. For the foregoing and other reasons, such as guarantee fees in non-US jurisdictions, as well as the complexity and cost of obtaining security in other jurisdictions, loan documents in the US often provide that a non-US subsidiary of the borrower will neither guarantee the loans nor pledge its assets, and the pledge of the subsidiary’s voting stock will be limited. In May 2019, the Treasury Department released final regulations under Section 956 of the US Internal Revenue Code of 1986, as amended, which have the effect of removing the US federal income tax impediment to a controlled foreign corporation, providing credit support with respect to debt issued by its parent US corporate borrower. This development will likely result in lenders pushing for guarantees and security from subsidiaries in non-US jurisdictions, and the negotiation will likely focus on weighing the costs of providing the guarantees and security to the US borrower against the benefits to the lenders.

### ii Tax considerations specific to non-US lenders

There are a number of US tax considerations specific to US borrowers and non-US lenders in corporate lending transactions. For example, if a lender is an offshore fund, it is not likely to join a syndicate in a US loan transaction until after initial funding has been made by other lenders. This is because doing so could trigger tax filing and payment obligations in the United States for the fund or its investors. In contrast, trading in outstanding securities acquired in the secondary market will not result in such obligations.

### iii US withholding taxes

In general, the United States does not require withholding tax on interest payments to US lenders, but it will require withholding tax on interest payments to non-US lenders in the absence of an available exemption. This tax is generally equal to 30 per cent of the gross amount of the payments made to the non-US person, and is required to be withheld by the borrower.
Lenders that are otherwise subject to the withholding tax may avail themselves of one of three exemptions to reduce or eliminate this tax:

- the ‘portfolio interest exemption’;
- treaty eligibility; and
- effectively connected income.

The portfolio interest exemption is available to a non-US person that is not a bank if certain conditions are met, many of which can be satisfied by including certain non-controversial provisions in the loan documentation, together with the submission of certain federal tax forms to the borrower certifying that the person is not a US person. In addition, if a non-US lender is resident in a country that has an income tax treaty with the United States, the provisions of the treaty may reduce or even eliminate withholding taxes. Finally, a non-US lender that makes a loan through a US branch that is engaged in a US trade or business will be exempt from US withholding taxes, but not US federal income taxes (imposed on a net basis), on interest payments made by the borrower. Most US loan documentation provides contractual protection against withholding by requiring the borrower to ‘gross up’ interest payments if withholding becomes payable, although this requirement is often limited to withholding that results from a change in law after the effective date of the credit agreement.

### iv FATCA

The Foreign Account Tax Compliance Act (FATCA) requires non-US financial institutions with US customers and non-US non-financial entities with substantial US owners to disclose information regarding the US taxpayers. FATCA became effective on 1 July 2014. If an institution or entity does not comply with FATCA, a 30 per cent withholding tax is triggered, and responsibility for collecting the tax generally falls on the US borrower. The tax is applicable on all payments normally subject to US taxation, such as dividends, as well as to income that is traditionally excluded, such as bank interest and capital gains. Payments of principal were also scheduled to become subject to FATCA withholding tax beginning as early as 1 January 2019, but in December 2018, the Treasury Department issued proposed regulations that would remove the requirement to subject payments of principal to FATCA withholding and noted in the proposal that companies could rely on the proposed regulations until the final regulations are adopted. Borrowers acting as withholding agents that fail to withhold will be subject to financial penalties. As such, loan documentation in the United States now usually requires a lender to provide information to the borrower upon request to prove compliance with FATCA, and that in any event FATCA withholding obligations will not benefit from any gross-up provisions.

### IV CREDIT SUPPORT AND SUBORDINATION

#### i Security

Taking a security interest in assets that are located in the United States is relatively streamlined, and is governed in most instances by Article 9 of the Uniform Commercial Code (UCC). In general, a security interest will attach if the collateral is in the possession of the secured party pursuant to agreement or if the borrower has signed a security agreement that describes the collateral, value has been given and the debtor has a right to the collateral. If all three of these conditions are met, the security interest ‘attaches’ and is enforceable. Notably, in the United States a single security agreement can effectively create a security interest in substantially all...
of the assets of a borrower. However, unless that security interest is ‘perfected’, it may not come ahead of other security interests taken in the same collateral, and perfection can differ depending on the assets comprising the collateral. Under the UCC, a lender may perfect its security interest in collateral by satisfying the requirements for perfection outlined in the UCC, and once perfected that security interest will take priority over all other security interests that are not perfected or that have been perfected subsequently. Each state has adopted variations from the standard UCC, so although they are generally very similar, the UCC adopted by the relevant state should be referred to when taking a security interest.

The most common way to perfect a security interest in assets covered by the UCC is to file a UCC-1 financing statement in the appropriate filing office. The UCC-1 financing statement generally requires the names of the debtor, and the secured party or its representative, and a description of the collateral. The description can be as general as ‘all assets’ but will more typically track the description of the collateral found in the related security agreement. UCC filing fees are typically small, and there are few, if any, other costs related to taking security interests in the property covered by UCC filings. For borrowers that are US corporations, limited liability companies or registered partnerships, the appropriate filing offices will be their respective jurisdictions of organisation. For non-US entities that do not have a filing system for perfection in their home jurisdictions (which is most other jurisdictions besides provinces of Canada other than Quebec), the appropriate filing office would be the District of Columbia. Although a UCC-1 filing will serve to perfect most collateral, certain kinds of UCC collateral, most notably deposit accounts and cash, can only be perfected by control or possession, most often by housing the account with the agent or another lender, or by entering into a control agreement with the bank where the account is located. In addition, some assets may be perfected by more than one method under the UCC, although one method may be preferable to another. For example, perfection by possession of a stock certificate will take priority over a UCC-1 financing statement that was filed earlier and covers the same stock.

In addition to deposit accounts, cash and stock noted above, there are a number of assets that are governed by special rules relating to perfection and priority or other special considerations. These include, but are not limited to, agriculture; aeroplanes; fixtures; intellectual property; letters of credit; vehicles; oil and gas, and other mineral rights; railcars; real property; satellites; ships; and warehoused inventory. The laws governing taking security interests in real property, for example, vary from state to state, generally take longer to satisfy and can involve significant costs. There are often recording taxes and fees imposed by state and local laws, which can be excessive, so lenders sometimes take assignment of mortgages in connection with new financings rather than enter into new ones. Loans secured by mortgages may be limited to the value of the property rather than the amount of the loan to avoid onerous mortgage taxes. To secure interests in intellectual property, such as registered trademarks, copyrights and patents, federal filings will be required that specifically list each item, and these filings must be updated for any property acquired afterwards.

Guarantees

Guarantees are commonly provided by parents, subsidiaries and side-by-side subsidiaries of a common parent in the US corporate loan market. In large-cap transactions, parent guarantees are often limited in recourse to the stock of the subsidiary borrower, although this is less often the case in middle-market loans. Subsidiary guarantees are typically full and unconditional, but they are often limited to guarantees from domestic subsidiaries to avoid adverse tax consequences to the borrower of a non-US guarantee (discussed in Section III),
and may be limited to wholly owned domestic subsidiaries. Guarantees may be supported by security interests in the guarantors’ assets to the same extent that the loans are secured by the borrower’s assets.

### iii Priorities and subordination

There are three primary methods of achieving priority in US corporate lending transactions:

a. possessing a prior, perfected security interest in the assets of the borrower or being the beneficiary of an intercreditor agreement establishing priority in liens;

b. being ‘structurally senior’ to the other debt; and

c. being the beneficiary of a subordination agreement.

When a lender obtains a first priority perfected security interest in the assets of the borrower in a US loan, the lender obtains the right to receive a priority distribution equal to the proceeds of sale (or value) of that asset to the exclusion of any other creditors (except for holders of certain statutory liens). This means that in the event of a foreclosure, bankruptcy or other liquidation, the secured lender will be entitled to be paid out of the proceeds of the assets securing the loans before any lender having a junior security interest or no security interest in the asset may be paid. Priority in liens is typically established by perfection, as discussed in Section IV.i, but it can also be established contractually by an intercreditor agreement. Lenders under a senior secured credit agreement may agree to allow the borrower to incur additional first lien indebtedness or second lien indebtedness, and enter into an agreement with the lenders of that indebtedness as to priority in security, as well as to how remedies will be enforced in respect of the collateral, among other things.

While achieving structural seniority in the US corporate loan market, like other markets, depends entirely on lending to a level within the borrower’s capital structure that is below the level to which another lender extends credit, contractual seniority is established by a subordination agreement. Contractual subordination is achieved by an agreement in which the subordinating creditor agrees that in the event of a bankruptcy or other distribution of assets of the debtor, any amounts otherwise distributable to the subordinating creditor will instead be paid to a specified creditor or class of creditors holding ‘senior debt’ until they are paid in full. The class of ‘senior debt’ is usually defined as all indebtedness for borrowed money whether now existing or incurred hereafter, as well as capital leases. It is not necessary that the subordination agreement be between the subordinated creditor and the senior creditor, and often the senior creditor is the third-party beneficiary of an agreement between the borrower and the subordinating creditor. Subordination terms in the United States also typically provide that if there is a payment default on the senior debt, no payment may be made on the subordinated debt until the default is cured or the senior debt is paid in full. In addition, many subordinated debt provisions state that, in the event of a non-payment default on the senior debt, there will be no payments on the subordinated debt for a specified blockage period, which typically runs between 90 and 180 days. Although subordinated debt issuances were common in the US market in the 1990s, they are relatively rare in the current US corporate loan market.
V LEGAL RESERVATIONS AND OPINIONS PRACTICE

i Legal reservations
There are no financial assistance laws in the United States, but a federal bankruptcy court can void a guarantee or the pledge of assets by a subsidiary or parent of the borrower if the guarantee is deemed a ‘fraudulent transfer’, meaning that the guarantor was insolvent at the time of the guarantee or was rendered insolvent, and the guarantee and the guarantor received ‘less than reasonably equivalent value’ for the guarantee. Given that both aspects of this test must be met for a guarantee to be deemed a fraudulent transfer, as long as a guarantor is solvent at the time of the guarantee, it does not have to receive equivalent value. Most states have similar fraudulent transfer laws, which can also be applied by the bankruptcy court to void the guarantee. This is less of a concern for parent guarantees than subsidiary guarantees, as a parent is typically deemed to have benefited from the loan to its subsidiary through its equity ownership.

ii Opinions practice
It is typically the borrower’s counsel that provides a legal opinion in respect of loans to the loan arrangers or agent on behalf of the initial lenders. The opinion will usually cover the following:

a the authority of the obligors to enter into the loan documents;
b the execution and delivery of the loan documents by the obligors;
c the enforceability of the loan documents;
d conflicts with laws;
e organisational documents and material agreement;
f the creation and perfection of security interests in collateral, which may be perfected by filing a UCC-1 financing statement;
g possessory stock pledges; and
h sometimes, collateral consisting of real estate, intellectual property, or deposit and securities accounts.

Depending on the jurisdictions in which the borrower and the guarantors are organised, there may be opinions as to authorisation, execution and delivery of loan documents, as well as to conflicts with organisational documents and perfection, by various local counsel.

iii Choice of law and enforcement of foreign judgments
In general, courts in the United States recognise choice of law provisions in contracts (sometimes subject to the requirement that the choice of law has a substantial relationship with the contract and the transactions contemplated by the contract) so long as the application of the chosen law would not be contrary to a fundamental policy of another jurisdiction with a materially greater interest in the determination of a particular issue and the application of the chosen law would not threaten public policy or violate any fundamental principle of justice. Similarly, US courts will enforce final judgments of foreign jurisdictions so long as, among other things, the judgments were rendered under systems that provide impartial tribunals and procedures compatible with the requirements of due process of law, the other court had personal jurisdiction and jurisdiction over the subject matter, and the cause of action was not repugnant to public policy.
VI  LOAN TRADING

Loan trades are made by either assignment or participation. Lenders typically trade in syndicated loans over the dealer desks of the large underwriting banks. In assignments, an investor becomes a party to the loan documents and participates as a ‘lender’ under the loan documents, including with respect to voting rights. As such, assignments are typically subject to a minimum threshold and will require the consent of the administrative agent and the borrower, which may not be unreasonably withheld. Upon an event of default, which is sometimes limited to payment and bankruptcy defaults, a borrower will lose its consent right. Investors may also purchase participations by entering into a participation agreement with a lender to take a participating interest in that lender’s commitment. The selling lender remains the holder of the loan. Consent is rarely required, and the participant has the right to vote only on items such as the rate, terms and release of all or substantially all of the collateral. Guarantees and security are granted to the administrative agent on behalf of all of the lenders, present or future, so new lenders benefit from them to the same extent as if they had been part of the original syndicate without the need for the guarantor to sign or otherwise approve the transfer documentation. Loan derivatives common in the US corporate loan markets include loan credit default swaps (LCDS), in which the seller is paid a spread in exchange for agreeing to buy a loan at par, or some other pre-negotiated price. If the loan defaults, the LCDX, an index of 100 LCDS obligations that are traded over-the-counter, and total rate of return swaps, in which case a purchaser buys the income stream from a loan with a 10 per cent down payment that serves as collateral and a loan from the seller, and is obligated to purchase the loan at par or cash, and settle the position upon a default.

VII  OTHER ISSUES

Many of the current trends in the US corporate loans market are borrower-favourable terms that were popular at the height of the economic boom in 2006–2007. When these features largely disappeared from the market during the financial crisis, many believed it would be several years before these terms would return, yet these terms have again become widely available to borrowers. In the current market, borrowers negotiating credit agreements have been aggressive in testing the limits of what the market will bear.

i  Covenant-lite

Covenant-lite deals remain a strong part of the US leveraged loan market. Some covenant-lite deals contain no financial covenants, but otherwise resemble traditional credit agreements. Other covenant-lite loans, in addition to lacking maintenance covenants, also have high-yield style incurrence tests allowing unlimited debt, liens, investments, restricted payments and acquisitions upon pro forma compliance with applicable incurrence ratios, providing the ability to reallocate previous transactions from fixed dollar baskets to ratio baskets, and providing for the incurrence of ratio basket without taking into account a simultaneous use of a fixed dollar basket. Covenant-lite credit agreements also allow for restricted payments, investments or payment of junior debt subject to grower baskets based increasingly on a percentage of adjusted EBITDA. In a growing number of covenant-lite deals, asset-based lending (ABL) structures are becoming more common, with a stand-alone term loan lacking maintenance covenants, and a stand-alone ABL revolver having a ‘springing’ fixed-charge coverage ratio tested only if borrowing availability falls below a specified level. In these structures, term loans usually have cross-acceleration to the ABL, rather than cross-default,
which prevents the term lenders from indirectly benefiting from the ABL’s financial covenant. In addition, ABL financial covenants have trended toward higher thresholds before testing is triggered, excluding outstanding letters of credit for purposes of testing the trigger and setting covenant levels at higher cushions over the financial model for the borrower.

If there is a cash-flow revolver instead of an ABL, the covenant-lite documentation has typically contained a financial covenant that applies only to the revolver and, in many cases, only if the revolver exceeds a specified threshold of outstanding borrowings. Breach of the financial covenant will not result in a breach of the term loan, or will only result in a breach of the term loan if the revolving lenders have not waived the default by the end of a 45- to 90-day standstill period. Until the expiration of the standstill, the revolving lenders will have exclusive rights to waive or amend the financial covenant or exercise remedies in respect of the breach.

ii Convergence of leveraged loans and high-yield markets
There is a continued convergence in the US leveraged loan and high-yield bond markets, resulting in term loan B facilities with high-yield style terms. Trends contributing to this convergence include the tendency for the same company to raise capital in both the leveraged loan and high-yield bond markets, a switch by loan arrangers to a fee-based business model, a shift in the emphasis from holding loans to syndication and trading, and the increased influence in the loan market of institutional investors, hedge funds and other investors familiar with the covenant structure of the bond market. High-yield style terms being adopted in the loan market include incurrence-based covenants and builder baskets as discussed above, as well as greater refinancing flexibility.

iii Refinancing facilities
In addition to incremental facilities, which have been common to US loan agreements for some time, credit agreements in many large-cap deals now include refinancing facilities. Refinancing facility provisions permit the borrower to refinance a portion of its existing credit facility with either new tranches of loans under the credit agreement or additional debt incurred outside the credit agreement. Debt incurred outside the credit agreement may be secured on a pari passu basis or by junior liens, in each case subject to an intercreditor agreement. This development allows the borrower to refinance loans with debt that is outside the credit agreement but still shares in the collateral, without requiring the consent of the lenders. Unlike incremental facilities, refinancing facility provisions rarely contain most favoured nation provisions affecting pricing.

iv Soft calls
If a prepayment premium is included for term loans in a large-cap deal, and even in some middle-market transactions, it now tends to be a ‘soft call’, meaning it is only payable if there is a ‘repricing event’. Repricing events occur when there is a refinancing at a lower interest rate or an amendment to reduce the interest rate. The soft call is typically priced at 1 per cent of the amount refinanced or repriced in the first six months or year of the loan. Some loans contain exceptions for refinancings where the primary purpose is not repricing, such as change of control transactions, qualifying initial public offerings and transformative acquisitions, investments and dispositions.
v **Stronger commitment terms**

In underwritten financings, borrowers with strong market power, including portfolio companies of strong equity sponsors, have been successful in obtaining committed financial covenant levels and agreement upon detailed financial definitions in the term sheet stage. Increasingly, other significant terms once reserved for negotiation in the definitive loan documentation are being agreed up front in the commitment papers, including material debt and lien baskets, restricted payment carveouts, builder baskets and other negative covenant carveouts. In many cases, these borrowers have controlled the commitment documentation, often using the sponsor’s ‘form’, and requiring the committing lenders to agree to a prior sponsor precedent as the guiding documentation for all items not specified in the term sheet.

vi **Loosened collateral requirements**

Commitment letters have started relaxing the scope of the collateral requirements that need to be satisfied at closing. They have begun to allow lien searches (sometimes excluded UCC liens) to be included in the list of items that can be delivered post-closing, and they have limited perfection of collateral at closing to those items that may be perfected by the filing of UCC-1 financing statements and to the delivery of certificated securities of US subsidiaries only, or even material US subsidiaries only. Large-cap deals now often eliminate the requirement for bank account control agreements, except in the ABL context, and an expansive list of excluded collateral has become standard, including excluding owned real estate valued below a specified threshold, all leaseholds, non-US collateral, assets securing receivables financings and any liens resulting in adverse tax consequences, among others.

**VIII OUTLOOK AND CONCLUSIONS**

The market for US loans remains relatively strong, in part because of a strong US economy, a continuing environment of low interest rates and a recent relaxation of the regulatory environment. At the same time, borrowers continue to have significant bargaining strength in negotiation commitment terms and debt terms, generally. The leverage loan market does face some vulnerability to the overall US economy, and current trends could change, especially when considering the current level of debt incurred by corporate borrowers deemed by the Fed as risky.
I OVERVIEW

Vietnam’s economy has achieved remarkable progress since the start of its transition from a centrally planned economy in the mid-1980s. However, since the 2008 global financial crisis, several segments of the economy had shown signs of poor performance and financial distress, which had affected the overall health of the banking system. From 2009 to 2011, interest rates rose dramatically due to high inflation, despite tightening monetary policies imposed by the State Bank of Vietnam (SBV). Access to credit was limited and the low overall liquidity in the banking system caused a race among banks to further increase deposit interest rates. In 2012, the burst of the real estate bubble triggered a crisis in the banking sector and resulted in a significant amount of non-performing loans (NPLs) in the system.

The crisis in 2012 led to a series of interventions and bank restructuring reforms by the government, which have shown results in recent years. Bank profits and asset quality are improving in most large banks. A strong economy and higher real estate prices facilitated the disposal of collateral and the restructuring of bad debts, raised profits and boosted capital. Interest rates decreased in general owing to high liquidity in the market. The government aimed to cut down lending interest rates by 0.5 to 1 per cent and increase loans for agriculture, hi-tech and supporting industries by more than 20 per cent. In 2018, the SBV wanted to further lower interest rates to incentivise economy sectors. However, there is not much room for this reduction given the current cost of financing. In the first quarter of 2019, deposit interest rates ranged from 0.5 to 1 per cent per annum for indefinite terms and 6.6 to 7.3 per cent per annum for a term of 12 months or more, and lending interest rates ranged from 6 to 9 per cent per annum for short-term loans and 9 to 11 per cent per annum for middle and long-term loans.

Credit growth in Vietnam is the highest in the region, rising to 18.7 per cent in 2016, 18.17 per cent in 2017 and 14 per cent in 2018, owing to a more consumer-oriented economy and a low interest rate environment. This trend is expected to continue until 2020. To control credit growth, the SBV has been imposing limits on the credit growth of each bank. Banks that meet the Basel II standards earlier than the 1 January 2020 deadline would be allocated a higher credit growth limit. By September 2018, most banks had reached the credit growth limits imposed by the SBV and only a few banks had been able to obtain an adjustment to these limits. The SBV also limits lending in the real estate sector by increasing the risk weight of real estate loans from 200 to 250 per cent and reducing the proportion of
short-term capital to be used for medium and long-term lending by banks from 50 per cent in 2017, 45 per cent in 2018 to 40 per cent in 2019. The SBV expects that both of these measures will reduce lending in the real estate sector because loans in this sector tend to be on a medium or long-term basis.

Partially due to the limit imposed on domestic credit growth, access to domestic bank loans has been difficult and foreign borrowing has increased sharply in recent years, at 44.8 per cent in 2016, 48.9 per cent in 2017 and 49.7 per cent in 2018 of GDP. The positive trends in both domestic and foreign borrowing growth, the corporate lending market in Vietnam is premature. Most foreign syndication loans use the Asia Pacific Loan Market Association (APLMA) form. Certain provisions of the APLMA form have been adopted and used in Vietnam by banks and law firms; however, there is no standard form for domestic transactions. Lenders in Vietnam are mostly traditional banks and credit institutions licensed by the SBV to conduct banking business. There is also no established market for transferring loan participations.

II LEGAL AND REGULATORY DEVELOPMENTS

i New lending regulations

On 30 December 2016, the SBV issued one of its most anticipated lending regulations, Circular No. 39/2016/TT-NHNN (Circular 39), to replace the old Decision No. 1627/2001/QD-NHNN, which was issued in 2001. Circular 39 provides for the principles, conditions, borrowing dossiers and interest rates of loans by commercial banks, credit institutions and foreign bank branches operating in Vietnam (banks) for business and consumption purposes. Below are the most significant changes introduced by Circular 39.

Eligible borrowers

Under the new lending regulations, non-legal entities (i.e., households, cooperative groups, and other organisations without a legal entity status) are no longer eligible to borrow from banks. In the case of borrowing for business and other activities, individual borrowers can borrow to meet their own capital needs and those of non-legal entity organisations.

Restricted borrowing purposes

Under the new lending regulations, refinancing loans are restricted. Circular 39 provides for a list of restricted loan purposes:

- carrying out business investment activities in industries and trades that are prohibited by law;
- paying the costs and meeting the financial needs of transactions and acts prohibited by law;
- purchasing and using goods and services that are prohibited by law;
- purchasing gold bars;
- repaying a loan at the same lending credit institution; or
- repaying debts at other credit institutions and repaying foreign loans.

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Under these provisions, refinancing loans is no longer permitted, unless the loans meet the following conditions set out in Circular 39:

a the loan is to repay a loan at the same lending credit institution as payment of the interest arising during the process of construction works where the interest costs were included in the total investment amount for construction approved by the competent authority; or

b the loan is to repay debts at another credit institution or repay foreign loans, in which case three conditions must be met:
   • it is a loan to serve business activities;
   • the term of the new loan does not exceed the residual term of the previous loan; and
   • the term of the previous loan has not been restructured.

**Interest and fees**

Prior to Circular 39, it was unclear whether bank loans were subject to the cap of 20 per cent per year imposed by the Civil Code 2015 on all civil transactions. This cap had impacted the consumer loan market because the lending rates in this sector tend to be much higher than 20 per cent per year. Lending rates for corporate and non-consumer loans were generally lower than this cap.

Circular 39 confirmed that bank loans are not subject to this 20 per cent cap. Banks and borrowers are free to agree on the lending interest rates, except for short-term Vietnamese dong-denominated loans in certain sectors. These include loans for the purposes of developing agriculture and rural areas, exporting, and supporting small and medium-sized companies, industries and high-tech businesses. This exception aims to incentivise the enlisted sectors, and interest rates in these loans are capped at the maximum lending rate announced on occasion by the governor of the SBV.

Though most banks welcomed the much-needed clarification on the 20 per cent interest rates, they also raised concerns on the cap imposed for loans in the incentivised sectors. This cap can potentially be counterproductive because instead of channelling more loans to the incentivised sectors, it could make lending in these sectors less attractive for banks, especially if the interest rates are lower than the banks’ cost of funds.

In addition, Circular 39 also imposes caps on overdue interests: 150 per cent of the regular interest rate with respect to the overdue principal amount (this is not a new change because it was also provided in the predecessor of Circular 39) and 10 per cent per year with respect to the overdue interest amount. These caps on overdue interest rates are viewed by many banks as too low, especially the fixed 10 per cent per year cap on overdue interest.

**Lending method**

Revolving and rollover loans were not formally permitted in Vietnam. Circular 39 now permits borrowers with financing needs for business cycles not exceeding one month to obtain revolving loans from banks with a term of up to three months. Rollover loans will also be possible provided that the borrower does not have any NPLs, and the total tenor of the rolled over loan does not exceed 12 months following the initial disbursement and does not exceed one business cycle of the borrower.
Loan currency
Circular 39 specifies that banks and borrowers may agree on the currency of the loans (if the loan is in a foreign currency, regulations on foreign currency lending will apply); however, Circular 39 requires that the loan must be repaid in the same currency it was borrowed in. Loans in foreign currencies by credit institutions are limited to certain circumstances enumerated by the SBV (e.g., short-, mid- and long-term loans for certain qualified import payments, short-term loans for manufacturing, and exports and loans for overseas investments that have been approved by the National Assembly or the Prime Minister of Vietnam). The SBV is expected to further restrict mid- and long-term foreign currency loans in the coming years.

Language
Under Circular 39, loan agreements will be prepared in Vietnamese, or in both Vietnamese and a foreign language. Therefore, the Vietnamese language is mandatory.

The order of debt recovery
Under Circular 39, banks and borrowers can agree on the order of debt recovery; however, if the loan is overdue, Circular 39 requires that the banks must first recover outstanding principal, and thereafter outstanding interest on the loan.

Basel II
For Vietnam’s banking system, Basel II standards have become an important requirement in the risk management and safety of the system. However, the application of Basel II in Vietnam remains slow.

In 2014, the SBV announced the trial application of the capital and risk management method in accordance with Basel II standards. According to this programme, 10 banks were selected to apply Basel II by the beginning of 2020. These banks are Vietcombank, VietinBank, the Joint Stock Commercial Bank for Investment and Development of Vietnam, the Military Commercial Joint Stock Bank (MB), Sacombank, Techcombank, Asia Commercial Bank, VPBank, Vietnam International Bank (VIB) and Maritime Bank. Basel II is implemented by Circular No. 41/2016/TT-NHNN (Circular 41) of the SBV. Under Circular 41, the deadline for these banks to meet Basel II standards is 1 January 2020.

Circular 41 implements the three pillars of Basel II:

a capacity adequacy ratio (CAR): the required CAR is at least 8 per cent. Under Circular 41, for the purposes of calculating CAR, equity includes Tier 1 and Tier 2 after deductions. Asset classifications are based on credit risk ratios; for example, zero per cent for gold, zero per cent for receivables from international financial institutions, and 90 per cent for receivables from small and medium-sized companies;
b supervisory review: banks must implement a comprehensive review of their capital adequacy and have a strategy to maintain their capital adequacy level; and
c market discipline: banks are required to disclose important factors of their business operations, risks and risks management. This is aimed to allow the market to gauge the capital adequacy of a bank.
As at April 2019, only six banks are recognised by the SBV as having successfully applied Basel II standards: Vietcombank, MB, VPBank, VIB, Orient Commercial Bank (OCB) and TPBank (OCB and TPBank are not among the initial 10 selected banks). It remains to be seen whether the remaining six of the 10 initially selected banks could meet the 2020 deadline.

**iii Sanctions and anti-corruption**

*Anti-money laundering and counter-terrorism law*


Under the AML laws and regulations, depending on the types of transactions and the factors relating to the customers or their transactions, a reporting person will have to comply with different types of AML and counter-terrorist financing obligations. These obligations include as follows:

- **a** create and maintain internal regulations on AML;
- **b** perform and collect know-your-customer information;
- **c** report and disclose information to the SBV and other competent authorities; and
- **d** impose temporary measures at the request of the competent authorities.

Notably, the threshold for the value of transactions to be reported is relatively low, approximately 300 million Vietnamese dong.

*New Penal Code*

In 2015, the National Assembly adopted a new Penal Code, which took effect from 1 January 2018. The most significant changes among those introduced by the new Penal Code are the expansion of corruption-related offences related to the private sector and the introduction of corporate criminal liability. Under the new Penal Code, individuals of any nationality working in the private sector can now be criminally liable for the offences of embezzlement, and the giving, receiving and brokerage of bribes, which were previously applicable to the public sector only. Together with this change, the definition of bribes was also broadened to include both tangible and intangible interests. The new Penal Code also provides, for the first time, for corporate criminal liabilities applicable to commercial legal entities. Accordingly, commercial legal entities can now be liable for offences of smuggling, tax evasion, securities and insurance-related offences, money laundering and terrorism financing.

*Sanctions*

Banks in Vietnam have been instructed by the SBV not to facilitate or engage in Iran-related transactions. Details of these instructions are unclear because they are ‘classified’. The SBV is concerned about potential penalties that may be imposed by the Office of Foreign Assets Control at the US Department of the Treasury if any Vietnamese bank were found to engage in or facilitate prohibited Iranian transactions. These penalties could include prohibitions against US financial institutions maintaining correspondent accounts in Vietnamese banks, which would effectively freeze any Vietnamese bank that is the subject of these penalties out of the global banking market. The main focus and concern of the SBV instructions is...
probably to protect the Vietnamese banking system, which has become very integrated into the global banking system, rather than any policy aimed at supporting the United States or, for that matter, the EU sanctions regime applicable to Iran.

In addition to the SBV instructions, Vietnamese banks are also tracking US, UN and EU sanctions because most Vietnamese banks now have international presence and their businesses are integrated into the international bank network and settlement systems.

### III TAX CONSIDERATIONS

#### i Withholding tax

A withholding tax of 5 per cent corporate income tax applies to interest paid on loans from foreign entities. Offshore loans provided by certain government or semi-government institutions may obtain an exemption from withholding tax where a relevant double taxation agreement or intergovernmental agreement applies.

#### ii Value added tax

Interest and other incomes of lenders relating to loans are not subject to value added tax. There is also no stamp duty or documentary tax applicable to loan agreements.

#### iii FATCA

On 1 April 2016, Vietnam and the United States signed an intergovernmental agreement (Model IGA 1B) on the Foreign Account Tax Compliance Act (FATCA), effective from 7 July 2016. Pursuant to Model IGA 1B, financial institutions in Vietnam will submit FATCA reports to the SBV, then the SBV will transfer the reported information to the US Internal Revenue Service (IRS).

On 7 August 2017, the SBV issued Official Letter No. 6226/TTGSNH (Letter 6226) guiding the implementation of FATCA in Vietnam in accordance with Model IGA 1B. Letter 6226 incorporates the entire contents of the FATCA guiding documents previously issued by the SBV in response to the requirements of the IRS, and follows the contents of Model IGA 1B. Letter 6226 is applicable to FATCA reports from 2016 onwards. Under letter 6226, the deadline for banks to submit their FATCA reports with the SBV is 15 August. The reporting format and data must follow the relevant requirements of the IRS. Banks must submit their FATCA reports in electronic format to the AML Department of the SBV.

### IV CREDIT SUPPORT AND SUBORDINATION

#### i Security

**Methods of security**

**Mortgage**

Mortgage is the most common form of security interest granted over property in Vietnam. By definition, a mortgage is a transaction in which the mortgagor uses its own property to secure the performance of the obligation to the mortgagee without giving possession of the property to the mortgagee. The core feature of a mortgage is that the mortgagor retains the use and possession of the mortgaged property. This feature distinguishes a mortgage from a pledge in which the pledgee takes possession of the property. As a result, a mortgage is typically
taken with regard to not only immovable property but also intangible property, which is physically undeliverable, and movable property if the lenders do not wish to take possession of the movable property. Mortgage will also be taken with regard to movable property if the possession of the movable property by the lenders will cause material consequences to the business and operation of the borrower (e.g., material machinery and equipment of the borrower).

Pledge

In a pledge, the pledgee will take possession of the property. Given this possession feature, a pledge is typically taken with regard to movable property only, and the law imposes on the pledgee an obligation to take care of and preserve the pledged property. If the pledgee loses, mislays or damages the pledged property, the pledgee must compensate the pledgor for the losses and damage.

Mortgages and pledges are forms of security transactions rather than forms of transfers of title to assets. Indeed, the transfer of title to the assets from the mortgagor or pledgor to the mortgagee or pledgee only occurs upon completion of enforcement of the mortgage or pledge.

Other forms of securities

The law also provides for other forms of security interests, including, among others, guarantees, securities by way of deposit, security collateral, escrow accounts, retention of title, pledges of trust and liens.

Assignments by way of security, even though generally accepted in many jurisdictions, are not recognised under Vietnamese law as a security transaction. Since an assignment by way of security is not among the forms of securities recognised by Vietnamese law, the creation of security over contractual rights, bank accounts and equity interests is generally achieved by way of a mortgage.

Assets available for security

Available secured assets

Under Vietnamese law, assets are defined to include objects, money, valuable papers (e.g., shares or bonds) and property rights valuable in money. Property rights are in turn defined to include, among others, rights to receive payment under contracts, rights to dividend and other equity interests, intellectual property rights and other rights arising from assets.

Assets are categorised in two ways: immovable or movable assets. Immovable assets include the following:

\[
\begin{align*}
\text{a} & \quad \text{land;} \\
\text{b} & \quad \text{houses and construction structures attached to land (e.g., buildings, plants);} \\
\text{c} & \quad \text{other assets attached to land, houses and construction structures; and} \\
\text{d} & \quad \text{other assets as provided by law.}
\end{align*}
\]

Movable assets are assets that are not immovable assets (e.g., equipment, inventory, bank accounts and securities).

Secured assets can be an existing asset at the time of the creation of the security or an asset to be created in the future (a future asset). Secured assets must be under the ownership of the securing party and be identifiable.
An economic organisation, subject to the land lease or allocation type, is entitled to mortgage the land use right and assets attached to the land to credit institutions authorised to operate in Vietnam. Although foreign bank branches, joint venture banks and wholly foreign-owned banks operating in Vietnam are also allowed to take mortgage of the land use right and assets attached to the land, the current laws do not, as yet, go so far as to permit foreign lenders to take such security interests, either directly or through a security agent established in Vietnam.

To conclude, foreign entities are only permitted to take a security interest over movable assets and property rights, including shares and rights relating to equity capital (other than property rights relating to immovable assets such as a land use right).

Rights under licences and regulatory approvals are sometimes used as secured assets even though the validity and enforceability of these securities are questionable because licences and approvals are generally issued to specific persons and are not assignable.

The most common secured assets are described below.

**Shares**

A pledge or mortgage over the shares held by shareholders of the borrower is allowed and can be perfected under the law of Vietnam. A mortgage is typically applied with respect to the security over non-listed shares, whereas a pledge is used for the security over listed shares because of the nature of blockading pledged shares at the Vietnam Securities Depository (VSD). The company issuing the shares is normally notified of the pledge or mortgage, and will acknowledge and consent to the pledge or mortgage.

**Movable and immovable assets**

As discussed above, current Vietnamese law does not permit foreign lenders to take a mortgage over land use rights or immovable assets located on land; it is, however, permissible for foreign lenders to take a mortgage or pledge over movable assets.

**Contractual rights**

A mortgage of contract rights (including rights under insurance contracts) is generally permissible and can be perfected under the law of Vietnam.

Lenders should consider requiring consent from the borrower’s counterparties for any mortgage of the underlying contracts. Counterparties should be required to give acknowledgment and consent providing for, among other things, (1) step-in rights enabling the lenders to replace the borrower as a party under the relevant project agreements, or (2) the requirement that any payment from the counterparties be made to the account designated by the lenders, or both. However, state-owned enterprises being counterparties may be reluctant to give such acknowledgment and consent.

**Receivables**

Vietnamese law specifically recognises a mortgage over receivables, which can be perfected under the law of Vietnam. Enforcement of receivables requires assistance from the relevant counterparties. Therefore, similar to the contractual rights, the borrower should be required to obtain consent from its counterparties for a mortgage over receivables.
Bank accounts

A mortgage of bank accounts and the balance standing to the credit of the bank account is allowed and can be perfected under the law of Vietnam. Conceptually, lenders and borrowers may have a contractual agreement on set-off of the loan obligation when due against the credit balances in the accounts of the borrowers opened with the lenders. In addition, the lender and the borrower may also agree that the lender is entitled to the credit balances in the accounts of the borrower opened with other banks for the payment of the loan obligation when due. In this case, authorisation by the borrower to, and undertaking to the lender by, the other banks should be procured.

Aircraft and vessels

Security over aircraft may be created by way of a mortgage or pledge, but security over vessels may only be created by way of a mortgage.

Creation and perfection of security

A security transaction is created by an agreement between the securing and the secured parties. There is no restriction under Vietnamese law on taking security over all or substantially all of the assets of a company. However, the security interests should not be documented in a single security agreement given that the security arrangement will be registered with the different registrars depending on the types and locations of the secured assets.

The security agreement will be effective as of the execution date, unless otherwise agreed by the parties or provided by law (e.g., a land use right mortgage agreement will be effective as of the time of registration in the cadastral register). The security agreement over the land use right or the security agreement over the land use right and assets attached to the land must be notarised or authenticated, except for where parties or a party to the security agreement are enterprises operating in real estate business; the notarisation must be implemented at a notary office and the authentication must be implemented at the commune people's committees.

Generally, security interest created over property in Vietnam will be enforceable against third parties as of the time when, inter alia, the security is registered, or the secured party keeps or holds the secured. Security over movable assets (other than aircraft and vessels), property rights and shares will be registered with the Centre for Registration of Transactions and Assets of the National Registration Agency for Secured Transactions (NRAST) under the Ministry of Justice of Vietnam. In addition to registration with the NRAST, the shares of public companies deposited with the VSD will be blocked by it upon creation of a security over such shares. The Civil Aviation Authority of Vietnam under the Ministry of Transport will register security assets being aircraft, whereas the Vietnam Maritime Administration, or maritime bureaus and port authorities as delegated by the Vietnam Maritime Administration, under the Ministry of Transport, will register security assets being vessels. Security over land use rights and assets attached to land will be registered in land registration offices under the Ministry of Natural Resources and Environment.

There are certain administrative fees related to the security transaction registration. The registration fee at the NRAST is 80,000 Vietnamese dong per application. For registration at a land registration office, the registration fee will be occasionally decided by the provincial people's council. For registration at the Civil Aviation Authority of Vietnam, the fee will be determined by the value of each security transaction, ranging from 1.8 million to 18 million Vietnamese dong. The registration fee at the Vietnam Maritime Administration...
is 80,000 Vietnamese dong per application. For voluntary securities blockade services at the VSD, service fees are determined based on the number of securities offered for the blockade, ranging from 5 million to 150 million Vietnamese dong.

**ii Guarantees and other forms of credit support**

**Guarantees**

The use of guarantees is common in the Vietnamese corporate lending market. A guarantee is an undertaking made by the guarantor to the beneficiary to perform an obligation on behalf of the guaranteed party when the obligation falls due and the guaranteed party fails to perform such obligation. The guarantor and the beneficiary may agree to use a security interest created over property such as a mortgage or pledge as security for the performance of the guaranteed obligation.

The beneficiary may not demand the guarantor to perform an obligation on behalf of the guaranteed party until the obligation falls due, and where the beneficiary is able to offset the obligation with the guaranteed party, the guarantor does not have to perform the guaranteed obligation.

**Standby letters of credit**

Vietnamese law is silent on the concept of a standby letter of credit as a security measure. However, a standby letter of credit is commonly used by Vietnamese credit institutions as a security measure. Generally, Vietnamese credit institutions describe a standby letter of credit as a guarantee of payment by a bank on behalf of its clients, in which the bank fulfils payment obligations if the client fails to fulfil a contractual commitment with a third party. Given the above, the standby letter of credit seems to fall within the scope of a guarantee under the law of Vietnam. By law, the guarantee arrangement (in the form of the standby letter of credit) to secure the payment obligations of the borrower with respect to the foreign loans should be included in the application for registration of the foreign loan to be submitted to the SBV for its approval of the foreign loan.

**Negative pledge undertakings**

Negative pledge undertakings are usually provided in facility agreements. These provisions may mitigate risk to lenders with respect of certain assets of the borrower or any obligor by not permitting the borrower or obligor to create security or quasi-security over any assets.

**iii Priorities and subordination**

**Priorities**

Payment priority is provided under Vietnamese law as follows:

- where all securities are registered, the payment priority will be determined according to the order in which the securities are registered;
- where there are both registered and not registered, the obligation for which the security is registered will be paid first; and
- where all securities are not registered, the payment priority will be determined according to the order in which the securities were created.
**Subordination**

Vietnamese law is silent on subordinated debt of enterprises (except for subordinated debts issued by credit institutions subject to the SBV’s regulations on prudential ratios and limits for operations of credit institutions). Subordination is generally left to be agreed by the parties. Vietnamese law provides that the order of priority for payment between the jointly secured parties may be changed if the jointly secured parties reach an agreement on changing the order of priority for payment as between themselves.

As a matter of practice, a creditor is entitled to contractually agree that its rights are subordinated to the rights of another creditor by an intercreditor or subordination agreement, subject to the rights of the parties possibly being limited by bankruptcy, insolvency, liquidation, reorganisation, or other laws of general application relating to or affecting the rights of creditors.

**Security sharing**

An asset may be used by the borrower as security for its performance of several obligations if, at the creation of the security transaction, the value of the asset is higher than the total aggregate value of the secured obligations of the borrower, unless otherwise agreed or provided by law. In addition, if the asset is enforced to fulfil an obligation that has become due, other undue obligations of the borrower shall also be deemed as due and all secured parties shall be entitled to take part in enforcement of the asset. If the parties wish to continue the performance of the undue obligations, it may be agreed by the parties that the borrower shall use other assets as security for its performance of the undue obligations, which may arguably be interpreted that the former asset is enforced to fulfil the due obligation only.

V  **LEGAL RESERVATIONS AND OPINIONS PRACTICE**

i  **Legal reservations**

There are certain limitations on the validity and enforceability of lending and security arrangements under Vietnamese law. Therefore, a legal opinion is normally qualified by reservations. Below are the most common reservations in legal opinions in Vietnam.

**Insolvency**

Rights of the parties may be limited by bankruptcy, insolvency, liquidation, reorganisation, and other laws of general application relating to or affecting the rights of creditors.

**Registration of a foreign loan**

SBV registration must be obtained for long- or medium-term foreign loans, renewed short-term loans having a loan term exceeding one year or non-renewed short-term loans having outstanding principal on the first anniversary date of the first disbursement (unless the loan is fully repaid within 10 days of the anniversary date). For the purpose of this registration, finance documents, such as a loan agreement, and security documents must be submitted to the SBV.

**Agency arrangement**

‘Agency arrangement’ is not a well-developed concept in Vietnam and is vaguely provided under Vietnamese law, which does not govern agency activities of a foreign entity. From a practical perspective, since the identity of the facility agent or the security agent, or both, is
described in the application for registration of the foreign loan with the SBV, it can be argued that if the foreign loan documentation has been examined and the foreign loan registration has been approved by the SBV, the SBV is deemed to consent to the foreign agency arrangement related to the foreign loan as set forth in the credit agreement.

**Choice of foreign law**

The choice of law rules for a civil contract involving a foreign element are provided in the Civil Code of Vietnam. A civil relation involving a foreign element is defined as follows:

a) at least one of the parties is a foreign individual or legal entity;
b) the parties are Vietnamese individuals or legal entities but the establishment, alteration, execution or termination of the relation arises in a foreign country; or
c) the parties are Vietnamese individuals or legal entities but the subjects involved in the relation are located in a foreign country.

The foreign law, notwithstanding being referred to, shall not apply in any of the following circumstances: the consequences of its application are inconsistent with the fundamental principles of Vietnamese law or the contents of the foreign law are not identifiable regardless of the application of necessary measures prescribed by procedural law.

**Enforcement of foreign judgments and awards**

Vietnamese courts will consider recognising and enforcing foreign arbitral awards where the awards have been made in, or by arbitrators of, a country that is a party to a relevant international treaty of which Vietnam is a participant or a signatory, for example, the New York Convention. Courts may also consider recognising and enforcing foreign arbitral awards on a reciprocal basis without the condition that Vietnam and the relevant country are signatories or participants of a relevant international treaty. A foreign arbitral award may be enforced only after the decision of the Vietnamese court recognising and permitting enforcement of the award has taken legal effect. Under Vietnamese law, a foreign arbitral award will not be recognised or enforced where, among others, the court in which the recognition and enforcement are requested determines that the recognition and enforcement of the award is contrary to the fundamental principles of Vietnamese law. In addition, courts will not recognise or enforce a foreign arbitral award in certain circumstances specified by laws.

A court will consider recognising and enforcing a judgment rendered by a foreign court where the judgment has been made in, or by the court of a country that is a party to a relevant international treaty of which Vietnam is a participant or a signatory, where the judgment is permitted to be recognised and enforced under Vietnamese law, or on a reciprocal basis without the condition that Vietnam and the relevant country are signatories or participants of a relevant international treaty. A foreign court judgment may be enforced only after the decision of the Vietnamese court recognising and permitting enforcement of the judgment has taken legal effect. Vietnam has only signed bilateral treaties on reciprocal enforcement of court judgments with a very limited number of countries (predominantly former communist countries) and is not a signatory to any multilateral international conventions with commitments on the reciprocal enforcement of judgments. Further, under Vietnamese law, judgments rendered by foreign courts will not be recognised or enforced where, among others, the Vietnamese courts determine that the recognition and enforcement of such judgments are contrary to the fundamental principles of Vietnamese law. In addition, the judgments must also satisfy all conditions for recognition and enforcement set forth in the relevant judicial assistance treaty to the extent that the judgments are recognisable and enforceable in reliance on the treaty.
Issues not covered by legal opinions

Normally, a legal opinion will not cover the tax, financial, accounting, commercial or technical matters, except for high-level tax advice. For example, the withholding tax of 5 per cent is imposed on interests and fees to be made by the borrower to the lender under the credit agreement in accordance with Article 13.2(a) of Circular No. 103/2014/TT-BTC (Ministry of Finance, 6 August 2014), guiding the performance of tax obligations of foreign individuals and organisations doing business in Vietnam or having profits in Vietnam.

ii  Legal opinion practice

The practice of delivering legal opinions is well developed in cross-border transactions in the lending market in Vietnam. However, delivering a legal opinion in a domestic transaction is uncommon. Legal opinions usually cover the capacity and authority of the borrower or other obligors, or both, and the validity and enforceability of the finance documents. Therefore, legal opinions are typically issued with the assumption about the correctness of all factual statements and representations as to matters of fact contained in each of the finance documents at the date when given and at the date of the opinion, and the assumption that the signatures of the signatories on behalf of the borrower or other obligors, or both, to the credit agreement are true and authentic.

The counsel to the lender will deliver a legal opinion. In some cases, the counsel to the borrower or obligor, or both, will give a legal opinion. Legal opinions are normally addressed to the lender in the case of bilateral loans and to the agent and the lenders in the case of syndicated loans. The provision of copies of legal opinions in some cases is permitted in respect of affiliates and professional advisors of the addresses on a non-reliance basis.

VI  LOAN TRADING

Even though trading of bilateral loans or syndication loan participations are permitted and regulated by several legal documents of the government and the SBV, there is no established market for loan trading in Vietnam. Loans are typically transferred by assignment of the right to collect debt between the loan seller and loan buyer (pursuant to the definition of 'loan sale and purchase' under Circular 09/2015/TT-NHNN of the SBV on loan sale and purchase by credit institutions and foreign bank branches, and under Decree No. 69/2016/ND-CP of the government on conditions for loan trading business). Novation is not recognised under Vietnamese law. For an assignment of loan, a notice to the borrowers of the assignment is required.

VII  OUTLOOK AND CONCLUSIONS

In 2019, the SBV released the credit growth target for the whole economy of only about 14 per cent, lower than 16 per cent in 2018. Banks will expect a slowdown in credit growth. However, economic growth in Vietnam will remain robust, and the banks' asset quality will improve, helping to strengthen their profitability. Strong economic growth will also translate into improvements in borrower repayment capabilities and enable banks to accelerate the write-offs of legacy problem assets. Moody's Investors Service, a credit rating agency, has recently changed its outlook for Vietnam's banking system from stable to positive for the next 12 to 18 months,5 reflecting a positive outlook for the Vietnamese economy and its banking sector.

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Rahayu obtained her law degree in transnational and diplomatic law from the Padjadjaran University, Indonesia (1995), and an LLM in banking and finance law from the London School of Economics and Political Science (LSE), London (1999).

At Rahayu & Partners, Rahayu was involved in a broad range of transactions, including foreign investments, projects and corporate finance, mergers and acquisitions, and general corporate commercial and dispute resolution. Rahayu is a seasoned advocate, a member of the Indonesian Advocate Association and a capital market lawyer, registered at and a member of the Indonesian Association of Capital Market Legal Consultants. Rahayu holds an Indonesian Risk Management Certificate from the BSMR. She is also an authorised sworn translator. An accomplished writer, she has contributed to several publications, including the International Financial Law Review’s *Banking Yearbook* on Indonesia (2002).

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Pedro Ravina Martín is a partner in the banking and finance practice area of the Madrid office, which he joined in 2004. In 2008, he was seconded to the in-house legal department of JP Morgan Securities Ltd in London for four months, and from October 2010 to October 2012 he was based in Uría Menéndez’ London office. From October 2013 to April 2014, Pedro was seconded to the New York headquarters of Wachtell, Lipton, Rosen & Katz.

His practice is focused on banking and finance, mergers and acquisitions deals (in particular, with financial entities), capital markets and corporate restructuring transactions.

Pedro has been involved in a number of investment and divestment projects in listed and non-listed companies, as well as in corporate and project finance transactions and corporate restructuring processes, advising mainly financial entities and private equity firms.

He regularly advises on regulatory aspects concerning financial activities (e.g., banking, investment services and payment services) and undertakings for collective investment. Pedro has acted for Spanish management companies and international investment banks in bond and mortgage security issuances (mainly covered bonds), as well as mortgage-backed and asset-backed securitisations, and other domestic and multi-jurisdictional structured finance deals.
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Gulong Ren is a partner at AnJie Law Firm. He specialises in acquisition finance, asset finance, commodity finance, debt capital markets, debt restructuring, general banking, project finance, real estate finance and structured finance. Mr Ren has advised various financial institutions, including major international banks and key Chinese lenders, as well as corporate entities. His experience covers a wide range of sectors, including financial markets, real property, infrastructure and transportation, mining and energy, pharmaceutical and healthcare.

Mr Ren obtained an LLM from the University of International Business and Economics in Beijing and an LLB from Shanghai International Studies University. He is admitted to the PRC Bar. He has authored several books on banking and finance practice.

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Yves Rutschmann has been a partner at Bredin Prat since 2003 and leads the firm’s tax team. He specialises in tax aspects of transactions (mergers and acquisitions, private equity, restructuring), and regularly advises firms and their directors in relation to international transactions. In parallel, his experience in tax audits and tax litigation enables him to work for both French and foreign companies on a wide range of subjects, ranging from tax raids to priority preliminary rulings on the issue of constitutionality. Yves Rutschmann is recognised as being particularly skilful in negotiations with the tax authorities, whether the matter at hand relates to a corporate transaction or to one of the various stages of litigation procedures.

He has written numerous articles on tax issues and tax consolidation, and also gives lectures in tax law at the French business school HEC Paris.

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Oludare Senbore is a partner in the firm’s corporate and commercial practice group, and heads the firm’s power team. He specialises in banking and finance, energy and natural resources, power and infrastructure, and project finance.

He advises on matters such as local and foreign currency syndicated lending, lease transactions, structured finance, project finance, mergers and acquisitions, structured trade finance, due diligence issues and advisory services, foreign investment advisory services, privatisation, real estate and the regulatory framework relating to utilities.

He has over 18 years’ experience in international financial transactions, such as non-recourse and recourse financing, acquisition financing and mezzanine financing, with specific focus on the following sectors: power and infrastructure, energy and natural resources.

Oludare has been included among the top finance lawyers in Nigeria by several leading international legal publications. In the 2019 edition of The Legal 500, Oludare was recognised as a ‘Next Generation Lawyer’ in the banking, finance and capital markets practice. In addition, Oludare was recognised by IFLR1000 as a leading lawyer in banking, mergers and acquisitions, and project finance.

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Carrie B E Smit is a partner and head of the tax group at Goodmans. Her practice encompasses all aspects of income taxation that arise in corporate and commercial transactions, including cross-border mergers, corporate reorganisations, domestic and international debt financings, debt restructurings and private equity investments.


Carrie has spoken at numerous tax conferences and has written papers on a variety of income tax matters. Carrie is a member of the Canadian Bar Association and the International Fiscal Association, and is a former governor and executive committee member of the Canadian Tax Foundation. She was admitted to the Ontario Bar in 1992.
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Menno Stoffer was admitted to the Bar in 1993 and has been a partner at De Brauw Blackstone Westbroek since 2001. He specialises in (international) financing and restructuring matters. He advises on a wide range of financing matters (banking, acquisition, asset, structured and project finance) in both a going concern context and in distressed or complex situations. In these matters, Menno combines a deep market practice knowledge and expertise with tactical and strategic advice for directors, management and lenders on how to deal with special situations. Menno acts for corporates, financial institutions and private equity investors. Menno has also practised law at De Brauw London and De Brauw New York.

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Karine Sultan has been a partner at Bredin Prat since 2012 and is a member of the financing team. She specialises in banking and capital markets, with a particular focus on acquisition finance, debt restructurings and real estate financing.

Prior to joining Bredin Prat in 2007, she was with Watson Farley & Williams, and Orrick Herrington & Sutcliffe.

She was born in Gabon and was admitted to the Paris Bar in 1999. She is a graduate of Lille 2 University of Health and Law (licence in private law 1996), ISC Paris Business School (1996) and Paris Descartes University (Paris V) (DESS in international business law 1997).

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Abe Sung is a partner in the banking and capital markets department. His main practice areas are banking and structured finance, and he advises many domestic and foreign financial institutions on a regular basis. He has been actively involved in many securitisation deals in Taiwan, leading his colleagues in several pioneering cases, including the first cross-border securitisation deal ever done by a Taiwanese issuer. He also contributed to the enactment of Taiwan’s Real Properties Securitisation Law and participated in a number of real estate investment trust issuances. According to Chambers Asia-Pacific’s survey, clients commend him for combining ‘commercial sense with an open mind’ and consider him ‘the first choice’ for structured finance.

In 2002, Abe Sung advised First Commercial Bank in an open bid for sale of non-performing loans, which marked the inception of the non-performing loans market in Taiwan, and since then has advised in more than 30 distressed-asset deals. He also advised
Taiwan’s Central Depository Insurance Corporation to dispose of the banks in crisis, again setting milestones – in this case, for the smooth transfer of bank assets and for operations to resolve insolvent banks as sound ones.

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Monica K Thurmond is a partner at Paul, Weiss, Rifkind, Wharton & Garrison LLP, where she serves as a deputy chair of the corporate department, and a member of the capital markets and securities and finance groups. She represents private equity sponsors and their portfolio companies in a variety of engagements such as leveraged acquisitions, first and second lien senior secured debt financings, initial public offerings, high-yield debt offerings, structured exchange offers, debt and equity tender offers, high-yield bridge financings and consent solicitations. Monica has been recognised by *The Legal 500* and *Chambers USA* for her work in finance and capital markets.

MARCEL TRANCHET
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Marcel Tranchet has a banking and finance practice that includes syndicated bank financings, leveraged finance, structured finance, project finance, workouts and recapitalisations, securities transactions, derivatives and regulatory matters.

Marcel joined Lenz & Staehelin in 2003 and became a partner in 2011. He heads the banking and finance practice group of the Zurich office. He worked at Cravath, Swaine & Moore in New York in 2005 and 2006. He studied at the University of St Gallen and at the Morin Center for Banking and Financial Law, Boston University.

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Britt Vanderschrick has a law master’s from the Catholic University of Leuven and completed an exchange programme at the University of Oslo. Britt joined ALTIUS in 2016. She specialises in banking and finance law. She acts for borrowers and lenders on different finance transactions (including syndicated loan transactions, debt capital market transactions and real estate finance transactions). Britt advises on loan and credit agreements, security interests (pledges and mortgages), finance regulations, regulatory issues, securities regulations, investment funds (undertakings for collective investment), insolvency rules and corporate governance rules in financial institutions.

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Nikolaus Vieten is a partner in the Frankfurt office of Hengeler Mueller. He received a diploma in business administration and his legal education from the University of Wuerzburg, and he obtained a doctoral degree for a thesis on constitutional limits to taxation from the University of Cologne. His practice areas include syndicated lending and acquisition finance as well as loan portfolio transactions. From 2005 to 2008, he worked as a director in a principal investment area of a leading international investment bank in London.
L VISWANATHAN

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L Viswanathan is chair of the finance, project and bankruptcy practice. Viswanathan advises leading banks, financial institutions and private credit providers as well India’s largest corporates on a broad range of transactions, including structured lending, corporate debt restructuring, strategic debt restructuring, and recovery of loans and investments.

Viswanathan has acted on a number of landmark transactions, including advising: the Indian lenders on the restructuring of the Dabhol power project; the syndicate of lenders and other national and international financial banks and agencies in the 4000 MW Mundra Ultra Mega Power Project; the syndicate of lenders in the refinancing of the acquisition financing obtained by Tata Motors; clients with respect to several road projects in India, including the KMP Expressways Limited; and the developers with respect to the privatisation and modernisation of the Mumbai International Airport, and the syndicate of lenders financing the Delhi International Airport.

Lauded for his ‘fantastic understanding of complex matters’ and his ‘thoughtful, innovative approach’ by *Chambers Global*, Viswanathan has been included among the top project finance, and banking and finance lawyers in India by several leading international legal publications. *IFLR1000* 2014 named him as a leading lawyer for energy and infrastructure. *Chambers Asia-Pacific* 2018 states that ‘whenever there was an issue that neither side could resolve, everyone would turn to Viswanathan to see what he felt. His views were seen as that of a senior authority, and both sides were happy to trust his judgement’ and that he is ‘one of the top lawyers in terms of reputation and seniority’. *Who’s Who Legal* notes that he is ‘recommended without hesitation’ by clients.

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Henri Wagner was the managing partner of Allen & Overy in Luxembourg from 2008 to 2018, and is the partner leading the banking and capital markets department. He specialises in capital markets (including issues on debt and equity securities, securitisations and repackagings, derivatives and structured finance) and international banking work (including syndicated lending, investment-grade and leveraged acquisition finance, debt restructuring and financial services regulatory matters). He has more than 25 years of experience working in these areas.
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He focuses his practice on mergers and acquisitions, corporate financing, foreign investment and capital markets. Recently, he worked on the acquisition of RBS NV by ANZ, the tender offer of Galaxy Far East Corp, the syndicated loan to Taiwan High Speed Rail Corporation, the initial public offerings of Kino Biotech and Sino Horizon, the acquisition by ASML of HMI, and aircraft leasing and financing transactions involving CAL and EVA.
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