IN-DEPTH

Acquisition And Leveraged Finance

EDITION 10

Contributing editors
Dan Maze and **Tracy Liu**
Latham & Watkins LLP

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In-Depth: Acquisition and Leveraged Finance (formerly The Acquisition and Leveraged Finance Review) provides a practical overview of the most common structures and methods used to finance acquisitions in major jurisdictions worldwide, along with the most salient features of the relevant legal and regulatory frameworks. With a focus on recent trends and developments, it offers incisive legal and commercial analysis for practitioners and market operators.

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Editors' Preface

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It was a muted start to the year for the acquisition and leveraged finance market due to a challenging macroeconomic climate. Interest rate hikes at one of the fastest paces on record, surging inflation (particularly in Europe, the United Kingdom and the United States), heightened geopolitical tensions and concerns over the prospect of a global recession have all continued to weigh on the market.

The combination of a higher interest rate environment and ongoing market volatility also put a strain on the balance sheets of many portfolio companies and the ability of businesses to delever organically. As M&A activity remained subdued for most of the year, sponsors turned their focus to managing their portfolio companies, primarily through incremental add-ons and liability management exercises. Amend and extend processes, in particular, have dominated leveraged finance volumes this year as borrowers and issuers look to tackle upcoming maturities amid the uncertain macroeconomic outlook.

In a continuation of a trend that accelerated in 2022, private capital providers continued to gain market share beyond their core mid-market offering. As rising rates put pressure on larger buyouts, there were also fresh opportunities for direct lenders to go deeper into the capital structure via mezzanine, payment-in-kind or preferred equity instruments. Private capital providers also demonstrated their flexibility and the breadth of their offering by providing alternative financing solutions to meet the diverse needs of sponsors looking to manage rising capital costs and the liquidity needs of their portfolio companies. However, after the high levels of activity in the past two years, private capital providers are starting to become more selective about deploying their funds. Underwriting banks, on the other hand, are beginning to show renewed appetite following the challenges they faced last year. As competition between the two products heats up, sponsors are now frequently running dual-track processes for financings with syndicated and private credit options to obtain the most favourable terms possible.

Moving into 2024, market sentiment is improving. Inflation in most major economies is showing signs of cooling, interest rate peaks are being predicted and there is enhanced clarity on the direction of the global economy. As buyers and sellers acclimatise to the higher interest rate environment and are better able to factor this into deal valuations, purchase price multiples are expected to more closely align. This should hopefully lead to a resurgence in M&A activity, given private equity sponsors still have record levels of dry powder to deploy. Amid these green shoots and renewed optimism, however, market participants are likely to remain cautious as there may yet be bumps in the road ahead. A ripple effect of China's slowdown may potentially be felt across the globe, as there remain concerns around the prospect of rising default rates and the risks of a recession that, although showing signs of abating, still continue to lurk.

Many thanks to everyone who has contributed to this year's edition, and a special thank you to Law Business Research. We sincerely hope that this edition of *Acquisition and Leveraged Finance Review* will be an interesting read for you in this current environment.

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Introduction

Australia has a long history of merger and acquisition activity, and consequently the debt financing of these acquisitions is a well-trodden path for lenders and borrowers alike. Traditionally, the senior debt financing of acquisitions in Australia has been the domain of the banks, international and domestic, with the local 'Big Four' banks often taking lead roles in relation to the arranging and underwriting of these facilities. However, consistent with the European experience, the market has recently borne witness to the emergence and proliferation of non-bank, institutional lenders.

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

Unitranche loans (a hybrid loan that rolls senior and mezzanine debt into a single debt instrument) remain popular, particularly with private equity sponsors, on the basis that they are nimble, flexible (particularly from a covenant perspective) and relatively easy to execute.

Year in review

As a result of the current macroeconomic climate, M&A-related activity has softened in Australia in 2023. The Australian market has been affected by the strong economic headwinds of inflation and increased cost of funding, as demonstrated by the Reserve Bank of Australia's decision to increase the official cash rate following 12 out of the past 16 RBA monthly meetings (including 10 consecutive meetings from May 2022 to March 2023). This increased cost of funding, together with geopolitical challenges (abroad and, to a lesser extent, closer to home with changes in leadership in the Australian federal and numerous state governments) and market uncertainty has led to reduced levels of M&A activity and lower syndicated loan market activity. The value of Australian syndicated lending decreased by 59 per cent over the first half of 2023 (year on year) relative to the same period in 2022 (US$27.16 billion in the first half of 2023, down from US$65.51 billion in the first half of 2022).[2] The total number of syndicated lending transactions in Australia was also impacted, with a decrease of 38 per cent over the first half of 2023 (year on year) relative to the same period in 2022 (71 deals in the first half of 2023, down from 115 in the first half of 2022).[3]

In the current economic environment, there have been fewer big-ticket M&A transactions, with mid-sized transactions shaping up to be more resilient. The support for acquisition financings has varied widely depending on the quality of the underlying credit, with banks and private credit funds frequently seeking to manage their risk by obtaining credit risk insurance for each transaction. The most notable M&A transactions in Australia to be announced in the first half of 2023 were both in the energy and mining space (Newmont Corporation's acquisition of Newcrest Mining for US$21.1 billion, and Brookfield and MidOcean Energy's US$12.3 billion acquisition of Origin Energy), driven in part by a focus in Australia on supply security and energy transition. These transactions are expected to complete in the last quarter of 2023, and are reflective of a tendency for current Australian M&A transactions to take longer to close than in previous years.

With a reduction in M&A transactions, refinancings and shorter-term loan extensions have been the dominant feature of loan markets in Australia in the first half of 2023. For example, nine of the 13 largest syndicated lending transactions to close in Australia in the first half of 2023 were corporate refinancings for mature borrowers (including Healthscope, Woolworths, Qantas and ESR). While environmental, social and governance (ESG)-linked loan issuance reduced globally in 2023, this decline was less dramatic in the Asia-Pacific region. In fact, the largest syndicated lending transaction in Australia so far this year has been the A$4.6 billion sustainability linked loan refinancing of AirTrunk's existing debt facilities that closed in August 2023. Other notable ESG-linked loans in the first half of 2023 include QIC's A$1.6 billion green loan to fund its share of Vector Metering and Atmos Renewables' A$850m and US$592.8 green loans.

In 2023, institutional lenders and private credit funds (including, more recently Australian pension or superannuation funds) have continued to gain significant market share in syndicated lending transactions. These non-bank lenders are attractive to sponsors, particularly for their willingness to provide a range of products not offered by the major domestic banks, such as unitranche or Term Loan B (TLB) financings that have 'covenant-lite' structures, payment-in-kind interest and flexible borrower-friendly terms. While the US TLB financing market remains affected by macroeconomic conditions and market uncertainty, the Australian unitranche market continues to be an attractive option (e.g., TPG Capital's
A$1.8 billion proposed acquisition of InvoCare is being financed with an A$800m unitranche facility). However, traditional bank loans are also being considered more frequently as a viable option by sponsors who have historically looked to raise debt in the unitranche and TLB financing markets, due to the banks offering competitive pricing and a willingness by some sponsors to forgo flexibility for economics in the current high interest rate environment (e.g., PAG recently obtained A$700 million of senior bank debt to fund its acquisition of Australian Venue Co).

Following a string of substantial government privatisations in past periods, which included the privatisation of a majority stake in the WestConnex freeway project
(A$9.26 billion), the New South Wales Land Registry Services (A$2.6 billion) and the Victorian Land Titles and Registry office (A$2.86 billion), there has been a continued deceleration in the number of privatisations and new infrastructure projects over the past few years. In 2022 and 2023, the more notable transactions in this space involved the refinancing of existing debt (e.g., Ausgrid's refinancing of A$1.525 billion of senior debt facilities in December 2022), as asset privatisation appears to be no longer politically attractive to current state governments. Rather, the more notable projects and project

financing transactions in 2023 have occurred in the private sector and reflect the increased focus of investors on sustainability and energy transition, as demonstrated by the US$2.47billion syndicated financing to partially fund Perdaman Chemicals and Fertilisers' A$6 billion urea project in Western Australia and the financing of Squadron Energy's A$4 billion acquisition of CWP Renewables.

There has been an uptick in real estate financing transactions in the Australian build-to-rent and social and affordable housing markets, with increased levels of both foreign investment and local investment, particularly from large global real estate funds and Australian superannuation funds. This growth has been driven in part by strong rental market demand and proposed government initiatives to remove certain tax and regulatory hurdles that may have previously deterred foreign investment in this sector.

Regulatory and tax matters

i Regulation of foreign investments in Australia

The Australian Foreign Acquisitions and Takeovers Act 1975 (Cth) (FATA) and its associated regulations (administered by the Foreign Investment Review Board (FIRB)) regulate the making of investments by foreign persons in Australian companies and assets (and in some cases offshore companies with the requisite Australian connection).

In general, the legislation regulates four kinds of actions:

1. significant actions;
2. notifiable actions;
3. notifiable national security actions; and
4. reviewable national security actions.

Significant or notifiable actions

The Treasurer has the power to make orders in relation to significant actions (including blocking them, ordering divestments or imposing conditions) if the Treasurer considers the transaction to be contrary to the national interest. Approval only must be sought for these if they are also notifiable actions or notifiable national security actions, but obtaining approval cuts off the Treasurer's powers (although the Treasurer can in certain circumstances reopen approvals). Notifiable actions are a category of transaction that requires approval. Most notifiable actions are also significant actions (meaning the Treasurer has the above powers).

Common significant, or significant and notifiable, actions are:

1. the acquisition of 20 per cent or more of an Australian entity that is valued above the current monetary thresholds (currently A$310 million, or A$1,339 million where a higher treaty threshold can be relied on and the business is not a sensitive business);
2.

the acquisition by a foreign person that is a foreign government investor of 10 per cent or more (and sometimes less than 10 per cent) of an Australian entity or business (subject to a *de minimis* exemption, where the acquisition is of an offshore entity with an Australian subsidiary that meets certain tests);

3. the acquisition of 10 per cent or more (and sometimes less than 10 per cent) of an Australian entity that carries on an agribusiness where the investment is valued above the then current monetary threshold;
4. the acquisition of an interest in land valued above the then current monetary threshold (which varies depending on the kind of land and who the acquirer is), unless an exception applies; and
5. the acquisition of 10 per cent or more (and sometimes less than 10 per cent) of an Australian media business.

A foreign government investor (FGI) in general includes a foreign government or agency, sovereign wealth funds, state-owned enterprises, public pension funds, public universities and the like, or corporations, trustees of trusts or general partners of limited partnerships where, in respect of the corporation, trust or limited partnership:

1. FGIs from one country hold 20 per cent of the interests; or
2. FGIs from multiple countries hold 40 per cent or more of the interests, subject to an exception for passive investors (which does not apply to the 20 per cent limb).

Many private equity funds are deemed to be FGIs because of the amount of investment from the above categories of investors.

Notifiable national security actions

The Treasurer has the power to make orders in relation to notifiable national security actions (including blocking them or ordering divestments) if the Treasurer considers the transaction to be contrary to national security (which is narrower than the national interest test above). These actions require approval. An action is a notifiable national security action if the action is taken, or proposed to be taken, by a foreign person and the action is any of the following:

1. starting a national security business;
2. acquiring an interest of 10 per cent or more (and in some cases less than 10 per cent) in a national security business;
3. acquiring an interest of 10 per cent or more (and in some cases less than 10 per cent) in an entity that carries on a national security business;
4. acquiring an interest in Australian land that, at the time of acquisition, is national security land; or
5. acquiring a legal or equitable interest in an exploration tenement in respect of Australian land that, at the time of acquisition, is national security land.

A national security business is one that is carried on wholly or partly in Australia whether for profit or gain and is publicly known, or could be known after reasonable enquiry, that the business:

1. is a responsible entity or direct interest holder of critical infrastructure assets as defined in the Security of Critical Infrastructure Act 2018 (this covers certain assets across 22 different kinds of critical infrastructure sectors, including: aviation, banking, broadcasting, data storage or processing, defence industry, domain name system, education, electricity, energy markets, financial market infrastructure, food and grocery, freight infrastructure, freight services, gas, hospitals, insurance, liquid fuel asset, port, public transport, superannuation, telecommunications and water and sewerage);
2. is a carrier or nominated carriage service provider to which the Telecommunications Act 1997 applies;
3. develops, manufactures or supplies critical goods or critical technology that are for military or intelligence use by Australian or foreign defence or intelligence agencies;
4. provides critical services to Australian or foreign defence or intelligence agencies;
5. stores or has access to information that has a security classification;
6. stores or maintains personal information of Australian defence and intelligence personnel collected by the Australian Defence Force, the Defence Department or an agency in the national intelligence community, which, if accessed, could compromise Australia's national security;
7. collects, as part of an arrangement with the Australian Defence Force, the Defence Department or an agency in the national intelligence community, personal information on defence and intelligence personnel, which, if disclosed, could compromise Australia's national security; or
8. stores, maintains or has access to personal information as specified in the above bullet point, which, if disclosed, could compromise Australia's national security.

National security land is any of the following that is in Australia, and is owned or occupied by the Commonwealth for use by the Defence Force or the Department of Defence:

1. an area of land or any other place (regardless of whether it is enclosed or built on);
2. a building or other structure;
3. a prohibited area, within the meaning of the Defence (Special Undertakings) Act 1952; and
4. the Woomera Prohibited Area.

It also includes land in which the Commonwealth, as represented by an agency in the national intelligence community, has an interest that:

1. is publicly known; or
2. could be known upon the making of reasonable inquiries.

Reviewable national security actions

Reviewable national security actions are transactions with an Australian nexus that are not significant actions, notifiable actions or notifiable national security actions. Like significant actions, reviewable national security actions do not have to be notified, but obtaining approval cuts off the Treasurer's powers (although the Treasurer can in certain circumstances reopen approvals). The Australian government encourages seeking approval for certain kinds of reviewable national security actions.

Call in powers

Reviewable national security actions and significant actions for which approval is not sought are subject to the Treasurer's 'call in' powers for a period of 10 years if the Treasurer considers that the transaction poses a national security concern.

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

In a finance context, there is an exception from this requirement if the interest is either held by way of a security or acquired by way of enforcement of a security, solely for the purpose of a money-lending agreement. This applies to persons whose ordinary business includes the lending of money (which is deliberately broad enough to capture institutions that are not authorised deposit-taking institutions (ADIs) and captures a subsidiary or holding company of a lender, a security trustee or agent, and a receiver or receiver and manager of an entity that holds or acquires the interest). This exception also applies to a 'foreign government investor', although in respect of an interest acquired by way of enforcement of a security, a foreign government investor is restricted in the amount of time it can hold an asset (12 months in the case of an ADI and six months in the case of a non-ADI, unless the foreign government investor is making a genuine attempt to sell the assets acquired by way of enforcement). The money-lending exception has more limited application where the security is over residential land, national security land or a national security business.

Where the acquisition is not politically sensitive, these approvals are generally provided as a matter of course, although the need for FIRB approval should be considered where security is being granted over material Australian entities and the imposition of conditions around tax, data handling and the like is becoming routine.

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

Note that the above is a summary only. Australia's foreign investment rules are notoriously complex and are affected by non-statutory guidance, and legal advice should always be sought.

ii Interest withholding tax

Interest withholding tax (IWT) of 10 per cent applies on gross payments of interest (or payments in the nature of, or in substitution for, interest) made by Australian borrowers to non-resident lenders (except where the lender is acting through an Australian permanent establishment or where other exceptions apply). IWT is a final tax and can be reduced (including to zero) by domestic exemptions, such as the public offer exemption, and the operation of Australia's network of double tax agreements (DTAs).

Under DTAs with Finland, France, Germany, Japan, New Zealand, Norway, South Africa, Switzerland, the United Kingdom and the United States, there is no IWT for interest derived by a financial institution unrelated to, and dealing wholly independently with, the borrower (subject to certain exceptions).

Under Australian domestic law, IWT may also be exempt where the debt satisfies the 'public offer' exemption (contained in Section 128F of the Income Tax Assessment Act 1936 (Cth)). Once the debt satisfies the public offer exemption, it is typically more marketable as an incoming lender remains entitled to the benefits of the exemption from IWT (subject to certain criteria being met). Broadly, the public offer exemption applies where an Australian company (or eligible unit trusts in certain circumstances) publicly offers certain debt instruments via one of several prescribed means, including (most commonly):

1. the debt instrument is offered to at least 10 persons, each of whom is carrying on a business of providing finance, or investing or dealing in securities in the course of operating in financial markets, provided each of those persons are not known or suspected by the borrower to be an associate of any of the other persons; or
2. the debt instrument is offered to the public in an electronic form that is used by financial markets for dealing in debentures or debt interests.

The type of debt that may qualify for the public offer exemption consists, broadly, of debentures (which are defined to include notes) and syndicated facility agreements.

If the debt instrument is in the form of a syndicated facility agreements, it can only benefit from the public offer exemption if additional conditions are satisfied, including (among other criteria) that:

1. there are two or more lenders where each lender severally, but not jointly, agrees to lend money (or otherwise provide financial accommodation);
2. the agreement describes itself as a 'syndicated loan facility' or 'syndicated facility agreement'; and
3. where the borrowers will have access to at least A$100 million at the time the first loan or other form of financial accommodation is provided.

An IWT exemption is not available where the issuer (or arranger acting as agent for the issuer) knew or had reasonable grounds to suspect that the debt instrument will be acquired by an associate of the Australian borrower:

1. who is a non-resident and the debenture or debt interest was not or would not be acquired by the associate in carrying on business through a permanent establishment in Australia; or

2. who is a resident and the debenture or debt interest was or would be acquired by the associate in carrying on business through a permanent establishment in a country outside Australia, unless the associate acquired it in the capacity of a dealer, manager or underwriter in relation to the placement of the debt instrument, or a clearing house, custodian, funds manager or responsible entity of a registered scheme.

IWT relief also applies to certain foreign pension funds and sovereign funds. The IWT exemption will only apply to foreign pension and sovereign funds with (broadly) portfolio-like interests in the borrower, being interests in an entity that are less than 10 per cent of total ownership interests and do not carry an ability to influence the entity's decision-making. Additionally, the IWT exemption for sovereign funds will only be available for returns on investments in Australian resident companies and managed investment trusts.

iii Thin capitalisation

Australia has a thin-capitalisation regime that can operate to deny income tax deductions for interest expenditure on overly geared Australian groups that have debt deductions over the *de minimis* threshold of A$2 million for an income year. For years of income up to the year ended 30 June 2023, there were three methods to calculate the maximum allowable debt of a taxpayer. Most Australian borrowers would have relied on the safe harbour, which in broad terms allows for Australian assets to be funded by up to 60 per cent debt. In the context of an acquisition, these provisions allow for the funding of acquired goodwill.

In addition, up to 30 June 2023, there was an arm's-length debt test, which broadly allows Australian groups to be debt-funded up to the maximum amount a third-party lender would be willing to lend (based on certain assumptions). This test has not typically been used as it is an annual test that requires an assessment of various quantitative and qualitative factors, including the prevailing debt markets and general state of the Australian economy. Another test, the worldwide gearing test, allows an eligible entity to gear its Australian operations, in certain circumstances by reference to the gearing level of its worldwide group.

There is currently legislation before Parliament proposing to change the methods available to work out allowable deductions under the thin capitalisation rule from 1 July 2023. The default test will be a fixed ratio test that, in broad terms, will limit interest deductions for an income year to 30 per cent of its 'tax EBITDA'. Broadly, this is worked out by taking the taxpayer's taxable income or loss for the income year and adding back net debt deductions, certain deductions for tax depreciation and capital works. Any net debt deductions that exceed this limit will be carried forward subject to the satisfaction of recoupment tests.

Where certain conditions are satisfied, a choice can be made by a taxpayer to apply the third-party debt test, which will essentially allow debt deductions attributable to third-party debt. Based on the proposed drafting, a lender will only be permitted to have recourse to a taxpayer's Australian assets for third-party debt to qualify. Furthermore, a taxpayer will be limited to using the proceeds of the debt to fund activities in Australia.

Finally, where a taxpayer is a member of a worldwide group with audited consolidated financial statements, it may be able to choose to apply the group ratio test which may, in

some cases, allow deductions for net debt deductions in excess of the amount permitted under the fixed ratio test.

Security and guarantees

i Common security packages

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

The PPSA introduced a uniform concept of a 'security interest' to cover all existing concepts of security interests, including certain mortgages, charges, pledges and liens. It applies primarily to security interests in personal property that arise from a consensual transaction that, in substance, secures payment or performance of an obligation. It also applies to certain categories of deemed security interests, so that like transactions will be treated alike. 'Personal property' is broadly defined and essentially includes all property other than land, fixtures and buildings attached to land, water rights and certain statutory licences.

In a typical domestic secured lending scenario, security is most commonly taken by the relevant security providers entering into a general security deed that covers all of the relevant security providers' assets and undertakings (the local equivalent of a debenture). Such an instrument can attach to all forms of 'personal property' (both tangible and intangible) and operates in a similar way to a debenture or security agreement. Accordingly, all-asset security can be obtained from corporate grantors simply and effectively.

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

To ensure priority and perfection, each of these security interests must be registered on the Personal Property Securities Register (PPSR), created under the PPSA, within 20 business days of the security agreement that gave rise to the security interest coming into force (with some forms of security interest requiring registration within a shorter timeframe, including on or prior to the date that the security interest is granted by the security provider). It is possible for the secured party to register a security interest on the PPSR on and from the time that the secured party believes, on reasonable grounds, it is (or will be) a secured party in relation to the collateral. While not mandatory, registration will generally ensure that the security interest retains its priority against subsequently registered interests and that it remains effective in the event of the insolvency of a corporate security provider. It is possible (and advisable) for lenders to search the PPSR to determine whether there are any prior security interests registered against the relevant entities in the structure (including the Australian-domiciled holding companies and targets, together with any offshore parents of these entities).

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

ii Issues with the grant of security

Financial assistance

Section 260A of the Corporations Act 2001 (Cth) imposes restrictions on a company providing financial assistance for the acquisition of its, or its holding companies', shares. Financial assistance includes not only the granting of security, but also the provision of guarantees and indemnities (among other things). While a transaction that breaches this restriction is not invalid, any person involved in the contravention of this provision may be found guilty of a civil offence and subject to civil penalties. This liability can be criminal where a person is dishonestly involved in a breach. This liability (both civil and criminal) can theoretically extend to the lenders.

The general prohibition on the provision of financial assistance is subject to certain exceptions. The most commonly utilised exception is the exception set out in Section 260A(1)(b) of the Corporations Act (colloquially known as the 'whitewash' process), which enables the shareholders of the company to approve the proposed financial assistance. Given that an acquisition financing will invariably involve the grant of target security, the financial assistance rules are particularly relevant to this form of financing. For this reason, security over Australian target entities is generally granted within an agreed period post-closing (typically no less than 30 days) following the completion of the whitewash. This restriction does not affect the grant of security by any Australian-incorporated special purpose holding company, or any offshore parent over its shares in an Australian-domiciled entity, which can be provided in a more timely fashion.

Corporate benefit

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

in so doing, will be deemed to be acting in the best interests of the company itself). Where Section 187 of the Corporations Act is not available, care should be exercised to ensure that the corporate security provider derives some benefit from granting the guarantee or security and that granting the guarantee or security is in the best interests of the corporate security provider.

A guarantee or security could be set aside by a court if that court finds that the directors of the security provider have breached their duties and the lender was aware of that breach.

Administration risk

'Administration risk' describes the risk for a secured party that its security becomes subject to a moratorium if an administrator is appointed to a corporate security provider (which the directors of that entity are likely to do if the company is or is likely to become insolvent). Subject to the consent of the administrator or court order, a secured party is not entitled to enforce its security during the moratorium. This will be the case unless one of the exceptions apply, with the key exception being where the secured party has taken security over all, or substantially all, of the company's assets and the secured party has enforced its security interest within the 'decision period'. The decision period runs for 13 business days from the date the secured party was given notice of the appointment of an administrator or the date that the administration begins.

Due to the above, a secured party who holds perfected security over only certain assets (and those assets alone do not comprise all, or substantially all, of the company's assets) will not be able to enforce its security during the moratorium. To address this risk where the primary collateral is limited to specific assets, a 'featherweight' security interest may be taken over all of the grantor's assets (other than the principal secured property) that secures a nominal sum.

Stamp duty

Mortgage duty is no longer payable in any Australian jurisdiction. Furthermore, while *ad valorem* duty is generally not payable on financing transactions, nominal duty will be payable on a finance document that contains a provision that effects or evidences a declaration of trust over non-dutiable property or unidentified property, and that document has been executed by any party in New South Wales or Victoria.

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

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

Under Australian law, transactions will only be vulnerable to challenge when a company does, in fact, enter into liquidation. Division 2 of Part 5.7B of the Corporations Act provides that a liquidator can bring an application to the court to declare certain transactions void. While an administrator is required, in its statutory report to creditors, to identify potential voidable transactions that may be recoverable by liquidator (if appointed), the administrator does not have standing to challenge these transactions.

There are several types of transactions that can be found to be voidable:

1. unreasonable director-related transactions;
2. unfair preferences;
3. uncommercial transactions;
4. unfair loans; and
5. creditor-defeating dispositions (often associated with illegal 'phoenixing' activity).

Except for transactions entered into by companies in voluntary administration, operating under a deed of company arrangement, under restructuring or subject to a restructuring plan, transactions held to be an unfair preference or uncommercial will only be voidable where the transaction was also an 'insolvent transaction'; that is, an unfair preference or uncommercial transaction that occurred while the company was cash-flow insolvent, or contributed to the company becoming cash-flow insolvent.

Each type of voidable transaction has different criteria and must have occurred during certain time periods prior to administration or liquidation. The relevant time periods are generally longer if the transaction involves a related party. For example, there are longer time periods for insolvent transactions involving a related party or entered into to defeat, delay or interfere with the rights of any or all creditors in a winding up may be voidable.

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

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

A creditor-defeating disposition occurs where company property is transferred and the consideration payable at the time of the agreement (or, where there is no agreement, when the transfer occurred) was less than the market value (or the best price reasonably obtainable), with the effect of preventing, hindering or significantly delaying property becoming available for the benefit of creditors in the winding-up of the company.

Upon the finding of a voidable transaction, a court may make a number of orders, including orders directing a person to transfer the property that was the subject of the impugned transaction back to the company in liquidation and orders directing a person to pay to the company in liquidation an amount that fairly represents the benefit received under the impugned transaction.

iv Ipso facto stay provisions

With effect from 1 July 2018, provisions were inserted into the Corporations Act giving effect to an automatic stay on the enforcement of *ipso facto* clauses in certain contracts entered into on or after that date.[4]

The automatic stay will apply where one of the following insolvency events occurs in relation to a company:

1. voluntary administration;
2. a receiver or controller is appointed over the whole or substantially the whole of the company's assets;
3. the company announces, applies for or becomes subject to a scheme of arrangement to avoid a winding-up;
4. the appointment of a liquidator immediately following an administration or a scheme of arrangement; or
5. the company is undergoing restructuring pursuant to the regime for companies with liabilities of less than A$1 million.

The automatic stay will not apply retrospectively (i.e., for agreements entered into prior to the new provisions coming into force). Relevantly, the automatic stay does not apply to other types of contractual defaults – for example, if the company has failed to meet its payment or other performance obligations under the relevant agreement.

The length of the automatic stay depends on which formal insolvency process applies to the company as follows (subject to a court order extending the stay):

1. scheme of arrangement: the stay will end within three months of the announcement, or where an application is made within that three months, when the application is withdrawn or dismissed by the court or when the scheme ends or the company is wound up;
2. receivership or managing controllership: the stay will end when the receiver's or managing controller's control ends;
3. voluntary administration: the stay will end on the later of when the administration ends or the company is wound up; and
4. restructuring: the stay will end on the later of when the restructuring ends or the company is wound up.[5]

Importantly, the automatic stay does not apply once or if a company executes a deed of company arrangement (DOCA). The automatic stay ends when the 'administration ends', that is when a DOCA is executed by the company and the deed administrator. Accordingly, if a company does execute a DOCA and needs the protection of the automatic stay, then subject to limited exceptions, it will need to obtain court orders.

Even though the automatic stay provisions came into operation from 1 July 2018 (and the provisions only apply to certain contracts entered into after that date), it was only in late January 2023 that an Australian court first considered the operation of these provisions. In *Rathner, Citius Property Pty Ltd (Administrators Appointed)* [2023] FCA 26, the administrators sought judicial directions as to the scope of the statutory *ipso facto* stay

as prescribed in
Section 451E of the Corporations Act. Even though the court made no specific order relating to the *ipso facto* stay, insolvency practitioners have welcomed the decision as the court identified that the clear language and purpose of the provision confirmed the stay provisions operate as expected (and as we have noted above).

The scope of the automatic stay, specifically what contract types, rights and self-executing provisions are excluded by the automatic stay are set out in the legislation.[6] Relevantly, syndicated loans (and derivatives) are excluded from the operation of the automatic stay, and rights under those contracts will remain available to the parties should a trigger event occur. Accordingly, the impact of these changes on acquisition financings (which contemplate a customary security package) is likely to be minimal.

By contract, bilateral facility agreements are not excluded under the relevant legislation and as such the automatic stay provisions will apply to agreements entered into after 1 July 2018. The Asia Pacific Loan Market Association has issued a recommended rider clause for lenders to include in bilateral facility agreements to assist a lender in accelerating the loan as against a guarantor of that facility where the borrower is subject to a relevant insolvency process. It is important to note that this right to accelerate the loan as against the guarantor will not operate where the guarantor itself is also the subject of a relevant insolvency process under the Corporations Act.

In addition, the automatic stay does not prevent secured creditors from appointing a receiver during the decision period pursuant to Section 441A of the Corporations Act (if they have security over the whole or substantially the whole of the company's property) or enforcing security interests over perishable goods or prevent secured creditors or receivers from continuing enforcement action that commenced before the administration.

Priority of claims

i Priority of claims on insolvency

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

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

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

Sitting outside this regime are secured creditors, who will have priority over unsecured creditors. The security granted in their favour will entitle them to priority for payment of amounts outstanding from the proceeds and realisations of assets subject to security

interests. There is one exception to this, which is that employee entitlements have a statutory priority to the proceeds of assets subject to a circulating security interest (formerly, a floating charge) on realisation by a receiver or liquidator to the extent that the property of the company is insufficient to meet these amounts.

ii Subordination and the enforceability of intercreditor arrangements

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

Structural subordination is, however, less common (with a notable exception for holdco payment-in-kind instruments, which have been gaining popularity in recent times). Accordingly, second-lien structures can be accommodated relatively easily from a local perspective, where contractual subordination is typically documented via an offshore law-governed intercreditor arrangement.

Unlike that contained in the Loan Market Association suite of documents, there is currently no market standard intercreditor in Australia. A set of intercreditor principles (primarily applicable to leveraged transactions) has been circulated within the market, although they have not been universally adopted. Accordingly, a number of the provisions that these principles attempted to standardise (e.g., drag rights, standstill periods, mezzanine information rights and release provisions) remain heavily negotiated.

Jurisdiction

i Consent to jurisdiction

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

ii Enforceability of foreign judgments

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

The FJA provides a framework, based on registration, for civil judgments made in prescribed foreign courts to be enforceable in Australia. This regime applies to judgments made by specific courts in prescribed jurisdictions, for example, certain Swiss, French, Italian, German and UK courts. Under the FJA, a judgment creditor of a relevant foreign judgment may apply to an Australian court for that judgment to be registered any time within six years of the last judgment in the foreign court. The judgment may be registered

if it is final and conclusive for a fixed sum of money (not being in respect of taxes, a fine or other penalty), and is enforceable by execution in the relevant foreign country. Registration gives the judgment the same force and effect as if the judgment originally had been given in the Australian registering court (subject to certain exceptions). Special rules are also applicable to the enforceability of New Zealand judgments. The registration may be set aside if the foreign court did not have the necessary jurisdiction over the judgment debtor, either because the judgment debtor did not reside or carry on business in the jurisdiction when the proceedings were brought or did not otherwise submit to the jurisdiction of the court.

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

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

In seeking to enforce a foreign judgment under either regime, a practical difficulty often encountered if the foreign proceeding was not defended is proving that the foreign court has the necessary jurisdiction over the judgment debtor. Where the debtor is a corporation, the applicant will need to show that the debtor carried on business within the jurisdiction of the foreign court, either by maintaining a branch office or by employing an agent with the authority to bind the company and to conduct business there on its behalf.

In respect of recognition of foreign insolvency judgments, Australia has enacted the UNCITRAL Model Law on Cross-Border Insolvency in the Cross-Border Insolvency Act 2008 (Cth). Australian courts recognise the jurisdiction of the relevant foreign court in which the centre of main interest is located and generally cooperate with foreign courts and insolvency practitioners.

Acquisitions of public companies

i Restriction on acquiring more than 20 per cent voting power

The Corporations Act restricts a person from acquiring a 'relevant interest'[7] in issued voting securities in a listed Australian company or managed investment scheme, or an unlisted Australian company or managed investment scheme with more than 50 members, where this would cause that person's (or someone else's) 'voting power'[8] in the relevant

entity to increase above 20 per cent or to increase (by any amount) from a starting point between 20 per cent and 90 per cent. There are two principal methods of acquiring control of an Australian publicly listed company or managed investment scheme: off-market takeover bids and schemes of arrangement.[9]

ii Takeover bids

Chapter 6 of the Corporations Act provides the framework for takeover bids under Australian law. A takeover bid can be made on-market or off-market, and does not require the support of the target (i.e., a bid can be made on a hostile or friendly basis). For both on-market and off-market bids, a bidder must prepare and send to the target security holders a document (known as a bidder's statement) that includes details of the offer, information about the bidder and certain other prescribed information (e.g., in relation to the bidder's intentions and its funding). The target must respond by preparing and issuing a target's statement including the target board's recommendation as to whether security holders should accept the offer, as well as any other material information, including an independent expert's report as to whether the transaction is fair and reasonable and in the best interests of shareholders.[10]

An on-market bid is made through a broker and can only be used to acquire securities in a listed entity. On-market bids are far less common than off-market bids because they require the consideration to be 100 per cent cash and, importantly, cannot be subject to any conditions. Accordingly, it will often be the case that an on-market bid is not a viable option, for example, because the bidder requires regulatory approvals or other conditionality, including most importantly a minimum acceptance condition to ensure the bidder reaches a relevant interest of 50 per cent (and obtains practical control) or 90 per cent (so it can 'squeeze out' the remaining shareholders and reach full ownership through compulsory acquisition). A bidder's financing arrangements typically also require security to be taken over the target's assets (which can only be assured in a 100 per cent ownership scenario).

An off-market bid essentially takes the form of a written offer to security holders to purchase all or a specified proportion of their securities (known as a 'proportional takeover bid'). The consideration can take the form of cash, listed or unlisted securities or a combination of the two. The offer must be open for acceptance for a period of not less than one month and not more than 12 months. All offers made under an off-market bid must be the same (unlike schemes of arrangement, discussed below).

Takeover offers are less commonly used where a bidder wishes to seek full ownership as they require the bidder to reach a relevant interest of 90 per cent of the target's securities through acceptances of the takeover offer when added together with any securities in which the bidder and its associates already have a relevant interest in, through a pre-bid stake or existing holding. In comparison, a scheme of arrangement requires (among other things) 75 per cent of shares cast by shareholders (or each class of shareholders) who attend and vote at the scheme meeting to approve the transaction, which if received (and certain other conditions are fulfilled) will result in full ownership of the target being acquired by the bidder.

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

Typical conditions include those relating to:

1. the non-occurrence of certain statutorily prescribed events (including some insolvency type events);
2. the non-occurrence of a material adverse effect;
3. the obtaining of any necessary regulatory approvals;
4. the absence of any legal restraints or prohibitions to the acquisition completing; and
5. the receipt of a minimum number of acceptances that, as discussed above, is usually 50 or 90 per cent.

The Corporations Act does prohibit persons from making a takeover offer if they are unable, or are reckless as to whether they are able, to complete the offer. The Australian Takeovers Panel has separately indicated that it expects that a bidder has a reasonable basis to fund a takeover bid, and where the bid is debt-funded a bidder would have binding commitments from its lenders at the time of announcing its offer and would not declare its bid unconditional unless it is highly confident that it can draw down on these facilities (i.e., binding funding arrangements are documented in final form and commercially significant conditions precedent to draw down have been satisfied or there is no material risk the conditions precedent will not be satisfied).[11] However, unlike other jurisdictions, such as the United Kingdom, there is no requirement to have these funding arrangements verified or for 'cash confirmations' to be provided by a financial adviser to the bidder.

iii Schemes of arrangement

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

The typical operation of a scheme in the context of a control transaction is for the scheme to effect the transfer of target securities to the offeror in exchange for a specified consideration. The consideration under a scheme can be structured such that security holders receive cash, listed or unlisted securities (known as 'stub equity') or a combination of the two. There is more flexibility under a scheme with respect to the structure of the consideration as, unlike in a takeover bid, it is not necessary for all offers under a scheme to be the same, more easily facilitating differential treatment of security holders. However, where the same consideration (or choice of consideration) is not offered to all shareholders equally, or if those shareholders have materially different interests under the scheme, this will usually result in the creation of classes of shareholders for voting purposes, who will each be required to vote in favour of the scheme to the thresholds noted above.

A scheme of arrangement is essentially a target-driven process, with the target preparing the necessary security holder materials and seeking the necessary orders from the court.

As such, a scheme requires the support of the target's directors and therefore is only a viable option in 'friendly' transactions.

As part of the court process, the offeror will be required to satisfy the court that it has sufficient funds to pay the scheme consideration and consummate the transaction. A target will usually require the bidder to provide evidence (in the form of debt or equity commitment letters) of its ability to pay the scheme consideration before it will enter into the agreement (known as the scheme implementation deed) to implement the scheme. On a practical level this often results in offerors seeking 'certain funds' funding from their financiers (i.e., binding commitments to provide financing subject only to the satisfaction of a limited set of conditions, the accuracy of certain material representations, the absence of major defaults and it still being lawful for the financiers to provide the facilities at the time of funding). It is not customary for a target to agree to any form of financing condition in a scheme implementation deed.

Schemes can also be used to implement corporate restructures, demergers and debt-for-equity transactions. Specific to creditors' schemes of arrangement, on 3 May 2021, the federal government undertook a public consultation inquiry with industry on improving creditors' schemes of arrangement to better support businesses, including by introducing a moratorium on creditor enforcement while schemes are being negotiated. The consultation aimed to assess whether the current creditor scheme of arrangement process is useful as a means of restructuring insolvent companies. In its current form, the scheme of arrangement process is typically used in relation to complex restructurings of large corporate groups, involve a high level of court involvement and, unlike other insolvency processes (such as voluntary administration), there is no automatic moratorium to prevent creditors from bringing claims against the company during the negotiation and formation of the scheme. The consultation also sought input on the efficacy of the current scheme of arrangement framework generally.

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

Outlook and conclusions

ESG considerations are expected to become an even more common feature in M&A activity as various stakeholders demand that companies operate in a sustainable way. These stakeholder demands have materialised in multiple ways, including, for instance, incoming ESG-focused investors and investment funds seeking out suitable investments for their capital, and this is also true for the debt finance market where financiers are prepared to offer financing with better pricing to borrowers that agree to ESG-related covenants. In juxtaposition to these sustainable outcomes, it is also expected that ESG considerations will drive M&A activity where incumbent shareholders apply pressure on companies to divest dirty assets that would have otherwise been tightly held, but have now become available on the market. For instance, Grok Ventures' recent influence applied to AGL to require AGL to act in an environmentally sound ways (including to bring forward the closure of certain coal-fired powerplants). Grok Ventures has also more recently acquired the Sun Cable project (to develop a giant solar farm in inland Australia and an

undersea transmission cable to Singapore) from administrators, demonstrating its ongoing commitment to invest in clean energy.

Aside from investor-focused ESG concerns and ESG-related shareholder activism, there has been increased regulatory focus on greenwashing in European jurisdictions. While there is currently no specific regime in Australia, the local regulator (the Australian Securities and Investments Commission (ASIC)) has announced that greenwashing is an enforcement priority in 2023. ASIC took its first formal enforcement action for greenwashing in October 2022, issuing penalties to an Australian listed company on the basis that it made representations that were factually incorrect, demonstrating that it is willing to implement regulatory rigour to enhance governance and accountability. It also brought its first civil court action against greenwashing in February 2023.

We anticipate that strong economic headwinds will continue to shape the next 12 months. Global political challenges, economic uncertainty, inflation and increased cost of funding (including increases in the cash rates, margins and establishment fees) are all factors that will continue to dampen M&A-related activity. As such, M&A-related activity will be driven by a search for stability and a flight to quality. Market sentiment towards Australia remains optimistic as dealmakers recognise that, notwithstanding the current global and economic uncertainty, Australia has attractive features (including legal certainty, robust regulatory frameworks, a relative low risk compared with regional markets and dynamic industries) that remain intact and available to support deal flow. There are also expectations of an increase in syndicated lending volumes next year as there is US$484 billion of loan debt maturing in 2024 in the Asia-Pacific region,[12] which should result in more refinancings and shorter-term extensions.

Endnotes

1 John Schembri is a partner and Erin Cartledge is a special counsel at Gilbert + Tobin. The authors would like to thank Peter Bowden, Anna Ryan, Nick Cooper, Sean Meehan, Deborah Johns, Julian Cheng, Hanh Chau and Anthony Whitaker for their assistance with the preparation of this chapter. ^ Back to section

2 Refinitiv, 'Global Syndicated Loans Review: First Half 2023'. ^ Back to section

3 Refinitiv, 'Global Syndicated Loans Review: First Half 2023'. ^ Back to section

4 An *ipso facto* clause is a contractual clause that allows one party to enforce a contractual right, or terminate a contract, upon the occurrence of a particular event; usually upon insolvency or a formal insolvency appointment (for example, the appointment of a voluntary administrator). ^ Back to section

5 See Sections 415D(2)–(3), 434J(2)–(3), 451E(2)–(3) and 454N(2)–(3) of the Corporations Act 2001 (Cth). ^ Back to section

6 These are contained in the Corporations (Stay on Enforcing Certain Rights) Regulations 2018 (the Regulations) and the Corporations (Stay on Enforcing Certain Rights) Declaration 2018 (the Declaration). The Regulations prescribe 42 types of contracts, agreements or arrangements that are excluded from the operation of the automatic stay, and rights in those kinds of arrangements remain available to the parties to those arrangements should a trigger event occur. Among the agreement types listed under the Regulations are, but are not limited to: contracts, agreements or arrangements that are a licence or permit issued by federal, state or local government; contracts, agreements or arrangements that are or are directly connected with derivatives and securities financing transactions; contracts, agreements or arrangements for the underwriting of an issue or sale of, or under which a party is or may be liable to subscribe for securities, financial products, bonds, promissory notes or syndicated loans; and contracts, agreement or arrangements that are or govern securities, financial products, bonds, promissory notes or syndicated loans. The Declaration declares 11 kinds of rights (including self-executing clauses that, when executed, provide those rights) as excluded from the operation of the automatic stay, and those rights remain available to the parties should a trigger event occur. By way of illustration only, the kinds of rights excluded by the Declaration include, but are not limited to a right: to terminate under a standstill or forbearance arrangement; to change the priority in which amounts are to be paid under a contract, agreement or arrangement; and of set off, combination of accounts or to net balances or other amounts. ^ Back to section

7 The meaning of 'relevant interest' is contained in Sections 608 and 609 of the Corporations Act, and includes being the holder of securities or having the power to exercise (or control the exercise) of a right to vote or dispose of securities. ^ Back to section

8 The meaning of 'voting power' is contained in Section 610 of the Corporations Act and broadly means the proportion of voting securities held by a person and its associates as percentage of the total voting securities of the entity. A number of people may be taken to be associates for this purpose as defined in Section 12 of the Corporations Act. This includes certain entities controlled by one person, two or more persons who enter into a relevant agreement for the purpose of controlling or influencing the composition of the entity or two or more persons who are acting or proposing to act in concert in relation to the entity's affairs.Australian Securities and Investments Commission (ASIC) has also issued regulatory guidance on explaining these concepts, see 'Regulatory Guide 5: Relevant interests and substantial holding notices', dated August 2020. ^ Back to section

9 The authors note that pursuant to Section 444GA of the Corporations Act, a deed administrator may transfer shares in a company that is subject to a DOCA, with leave of the court. Leave will only be granted if the court is satisfied that the transfer would not unfairly prejudice the interests of members of the company. Section 444GA operates in parallel to all other prohibitions set out in the Corporations Act, such that if the acquisition of shares in the company that is subject to a DOCA will result in a person or their associate acquiring more than a 20 per cent interest in the company, an exemption granted by ASIC must be sought. ^ Back to section

10 Technically, this is only required in a takeover bid context in limited circumstances, including where the bidder has voting power in the target of 30 per cent or more or where the bidder and target have mutual directors. However, an independent expert's report is routinely and voluntarily sought by the target even where not strictly required. An independent expert's report considers the fairness (i.e., price) and reasonableness of the offer (i.e., other factors or broader circumstances), and concludes whether the transaction is in the best interests of shareholders. ^ Back to section

11 Australian Takeovers Panel, 'Guidance Note 14 – Funding arrangements'. ^ Back to section

12 Debtwire, 'Loan Highlights 2Q23: Running around – Loan volumes fall on hard times in 1H23'. ^ Back to section

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Introduction

The Brazilian M&A market has gained momentum during the past decades following a period of economic stabilisation and growth that led the country to investment-grade status, consolidating Brazil's place among the largest and most important global investment destinations. However, the investment community has been reluctant concerning the ability of Brazil to sustain this status, given the roller coaster-like backdrop that makes Brazil the country of 'future promises', blending years of economic growth with tumultuous political landscape, resulting in market agents operating in wait-and-see mode for the past few years. For M&A practitioners who insist on seeing the bright side of things, some side effects of the crisis (e.g., opportunistic distress scenarios and a devalued exchange rate[2]) may bring about an uptick in M&A activity as seen in the past decade and intensified during the past few years, which hopefully will preserve the country's status as a super-emerging market.[3] The main drivers of M&A activity in Brazil in the past have included:

1. increased interest from foreign investors that identify Brazil as a key strategic market;
2. consolidation in certain industries led by local leaders;[4]
3. amplified participation by the government through public pension funds, government-owned entities and banks; and
4. private equity funds taking centre stage in the M&A arena.[5]

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

In addition to challenging macro and regulatory bases, historically highly volatile interest rates – the benchmark interest rate (SELIC) set by the National Monetary Council reached a 21-year low during the first semesters of 2020, at a staggering 2 per cent, but the inflationary scenario quickly overturned this trend and the rate was stabilised at 13.75 per cent in the second semester of 2022[6] – resulted in M&A activity developing without the backup of a well-developed acquisition finance market. Banks dominate the lending market, with limited activity in debt capital markets. Only large companies can issue debt in the markets at competitive costs, which also results in lack of liquidity and a weak secondary market.

Leveraged buyouts (LBOs) as traditionally structured in the United States or other developed markets used to be scarce. The excessive cost of high-yield debt and the low liquidity in capital markets means that leverage has not historically been the most efficient form of financing in strategic or private equity deals.[7] However, influenced by the major global private equity firms putting down roots in Brazil, a local LBO market has started to develop, albeit to a limited extent. Moreover, the utilisation of leverage by large strategic buyers in the local market helps to instil LBO-like characteristics in acquisitions, thereby advancing the acquisition finance market in Brazil. In the local market, acquisition finance deals are driven either by the size of the cheque or the borrower's industry. Agribusiness

may benefit from trade finance facilities, while major infrastructure players are able to issue incentivised debentures to finance infrastructure projects.

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

In the first year of a new term for President Lula, despite concerns in fiscal policy and increased governmental spending, the interest rates are on a downward trajectory, setting a more optimistic scenario for leveraged acquisitions as M&A activities pick up with the overall sentiment improvement across the world.

i Structuring

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

ii Borrowers

Although sponsors are becoming more common in the Brazilian M&A arena,[8] most acquisition finance deals are struck by large strategic buyers that can leverage their relationship with local banks and obtain cheaper financing costs. This evidences that the local culture in acquisition finance is to provide credit to the buyer rather than to the target, with credit decisions made more based on the soundness of the buyer and less on the ability of the target to generate free cash flows.

iii Lenders

Financing is primarily provided by local banks. Syndicated deals and bond (debentures) underwriting structures are less common (except in infrastructure deals), and banks tend to commit and hold these loans in their books. The lack of a well-developed secondary market affects the ability of banks to use 'best-efforts' structures and spread the risk with institutional investors. This increases costs and limits credit supply in the market. Coupled with the high costs to hedge foreign exchange exposure and the high concentration of the Brazilian financial system in the hands of local players,[9] this scenario substantially hurts the competitiveness of foreign players in acquisition finance. Lower interest rates are available through subsidised loans granted by government-owned banks, notably the Brazilian Development Bank (BNDES). The prominence of BNDES has increased significantly[10] in the past two decades as it provided financial support to several important M&A transactions[11] in the Brazilian market at interest rates substantially below the policy rate.[12] However, the BNDES has taken a completely different approach in the past couple of years (mainly as a result of the current government's position towards BNDES funding) and has notably slowed down its direct involvement in the lending space.[13] This fact is

expected to increase the relevance of capital markets solutions in acquisition financing in the near term.

The emergence of capital markets (including pure play 'credit funds') as a player in the LBO market is caused mainly by the banks' risk aversion (after the covid-19 outbreak). The natural consequence is that the fixed income capital pool is migrating to private credit, with a number of private credit asset managers and investors migrating to this asset class and pouring liquidity into the market.[14] In a recent trend that links to the privatisation efforts of the latest administrations, we saw a spike in mega-deals involving the sale of government-controlled assets, such as several divestitures of Petrobras. These deals were backed by leverage components on bank deals that also used a newfound capacity in capital markets, such as Engie's acquisition of TAG (Petrobras' natural gas pipes subsidiary) and Mubadala's acquisition of Mataripe oil refinery. For instance, the TAG transaction has been financed by a syndicate of 10 banks, including the top Brazilian banks and some international names such as Mizuho, BNP Paribas and ING (it is speculated that 70 per cent of the price was financed, a true LBO in the context of a privatisation).

iv Leverage levels

As expected in view of high financing costs, leverage levels tend to be lower in Brazil when compared with those of US deals. While it is not unusual to use a debt-to-finance ratio of 60 to 80 per cent of the purchase price in a US LBO, in Brazil this ratio rarely reaches the 50 per cent mark.[15] To put things in perspective, while in developed markets financial leverage drives on average 33 per cent of private equity returns, in Brazil this number is only 3 per cent, leaving all upside to operational improvements and growth.

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

Regulatory and tax matters

i Regulatory overview

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

Broadly speaking, financial institutions are regulated by the Central Bank. Only those institutions authorised by the Central Bank are legally allowed to originate and provide credit on a regular basis as their main activity.[16] The risk for institutional investors or other entities that engage in the provision of loans or credit origination is to be deemed financial institutions without proper authorisation, which can lead to severe sanctions, including in the criminal sphere.

Under the above scenario, a non-financial investor may invest in credit instruments but should be careful not to engage in credit origination and lending with proprietary capital as its principal activity.[17] Although traditional capital markets financing and secondary markets remain timid in Brazil (owing to the combination of high interest rates and the prominence of large banks and government banks as the main agents of credit), a number of alternative credit markets have developed to fill the void.

Among these alternative funding structures, the development of securitisation is noteworthy. Securitisation structures cover a wide spectrum of receivables, ranging from personal banking loans to complex infrastructure projects, fostering the development of a credit secondary market. Two important regulatory milestones in the early 2000s helped foster this market: the creation of financial securitisation companies[18] and the emergence of receivables funds (FIDCs), regulated both by the Central Bank and the CVM.[19]

While financial securitisation companies never gained much traction, FIDCs became a popular, widely used alternative structure to the traditional funding sources in Brazil.[20] Factors such as favourable tax treatment and structuring flexibility attracted several local and foreign investors, leading FIDCs to post double-digit yearly growth in assets. Currently, in excess of 50 billion reais are under management by FIDCs, and industry experts forecast that this could reach over 180 billion reais in the next 10 years. However, the utilisation of FIDCs and securitisation structures has been less common in leveraged finance structures.

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

Most private equity deals in Brazil are structured through the previously mentioned special type of investment fund, FIP. FIPs emerged in 2003 in an attempt by regulators to provide financial sponsors with a sophisticated and flexible structure to conduct investments in Brazil that offered clear advantages compared to the traditional corporate structures.[21] Several features, including tax incentives, contributed to the success of FIPs and ultimately to the reshaping of local M&A deal structuring.[22]

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

ii New regulatory topics

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

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

A new Anti-Corruption Law became effective on 29 January 2014. Although not aimed specifically at financial institutions or institutional investors, its close ties with anti-money laundering provisions make it a hot topic for lenders. The new law brought about

heightened anti-corruption standards, including the introduction of concepts from the Foreign Corrupt Practices Act and the mandatory introduction of anti-corruption policies and compliance training within companies.[23] Financial institutions already subject to anti-money laundering have to adapt current structures to comply with the provisions of the Anti-Corruption Law, and this trend can be seen in acquisition finance structures already (banks are requiring targets to represent compliance with anti-corruption law).

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

1. the emergence of multiple opportunities to acquire assets and companies that were fundamentally successful but implicated in corruption scandals;
2. the need for buyers and finance providers to measure and protect against the risk arising from compliance and corruption-related actions in the target companies;
3. heightened due diligence standards;
4. contractual implications, mainly related to buyer projections, termination events and material adverse changes; and
5. the need for specific legislative regimes to ensure limitation of liability for buyers of toxic assets, to preserve economic activity.

The fact that several of the players involved in corruption scandals ended up in court protection regimes[24] may relieve some of the concerns resulting from specific protections afforded to purchasers by the Brazilian Bankruptcy Law,[25] but there are still uncertainties related to some succession risks (such as corruption losses) that will require adaptation from agents in the market and will create a new baseline for the definition of 'market' in deal documents.[26]

Social-environmental risk management

Until 2012, the observance by local financial institutions of social and environmental standards in lending and financing activities was voluntary. Some major players had set up independent structures to comply with international accords such as the Equator Principles.[27] In April 2014, the CMN extended the social-environmental responsibilities to all entities operating under the Central Bank's authorisation[28] by introducing the social-environmental risk policy (PRSA). Financial institutions must observe this policy not only for their own activities, but also when providing financing to entities.[29] As financial institutions are rushing to adapt their structures to comply with the PRSA, it is unclear to what extent the enforcement of the new policies will take place and how strict the supervising authorities will be. The new rules mandate the creation of policies, tools and controls, but do not extend liability to the financial institutions for damages caused by their clients. The PRSA should certainly be on the radar of market players structuring LBOs in Brazil.

In addition to these topics, the antitrust law reform of 2011 affected the M&A market and, consequently, acquisition finance structures: from June 2012, Brazil became a 'pre-merger system', under which merger reviews by antitrust authorities are conducted

pre-closing, unlike the previous post-factum reviews. Broad gun-jumping provisions may also cause uncertainties to parties in M&A situations. Waiting periods and conditions precedent-related to antitrust approvals should always be kept in mind by lenders while negotiating leveraged acquisition structures.[30]

iii Tax aspects

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

In the acquisition finance space, the hot tax topic is the discussion of interest expense deductibility in LBO transactions. In deals with LBO features,[31] tax authorities have frequently questioned the ability of the target to deduct interest expenses for tax purposes. The main argument used by tax authorities relates to the fact that excessive indebtedness was not necessary for the day-to-day operations of targets. We are aware of a few precedents in which tax authorities have issued notices of tax assessments to LBO targets that allegedly used excessive leverage to pay less tax (these cases are under discussion with the tax authorities). However, we can say that this type of challenging of tax authorities has become more common in the past couple of years.

Tax law experts have taken a critical stance on the positioning of the tax authorities,[32] which can be credited to the tax authorities' lack of understanding of the LBO structure and its benefits in advancing corporate development. Among their arguments to challenge these views, experts include:

1. the business and financial reasoning behind LBOs;
2. from the legal and financial standpoints, the success of the structure in several jurisdictions;
3. the fact that tax statutes foresee specific situations whereby holding company structures are used for acquisition and tax deductibility arising therefrom;[33] and
4. a presumption in the tax laws that interest expenses are generally deductible.

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

So far, the Tax Payers Council (the administrative body responsible for the analysis of tax infractions notices issued by tax authorities in Brazil) has adopted a favourable position when dealing with this matter. Recently, the Tax Payers Council issued a decision recognising the deductibility of the interest expenses incurred upon an LBO transaction, stating that loans taken to finance acquisitions of equity interest should be considered as a common and regular operation. In addition to this good precedent, a recent reform on mergers and consolidation rules for public companies enhanced the list of arguments to defend this position. In the past, the reverse merger of a leveraged financing vehicle into a listed company was considered abuse of control power and this was used as an argument by tax authorities, but this restriction was lifted in the CVM's rule governing the matter.[34]

Objective limitations to interest expense deductibility in LBO structures include:

1. leverage being connected to an acquisition performed at market conditions;
2. all records and documentation relating to the interest expense being present;
3. actual utilisation of the funds to perform the acquisition; and
4. observance of the transfer-pricing[35] and thin-capitalisation rules in cases where the beneficiary is considered a related party or is domiciled in a tax haven jurisdiction.

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

Security and guarantees

i Fiduciary sale

When structuring debt deals and acquisition finance guarantee packages, the main goal of lenders is to ensure quick access to assets, preferably without bankruptcy and insolvency risk. In this scenario, the fiduciary sale or assignment in guarantee[36] has become the most common type of guarantee in the financial markets. Law 10931 of 2 August 2004, which amended Law 4728 of 14 July 1965, extended the application of the fiduciary sale to transactions executed within the financial and capital markets, which prompted an exponential increase in the use of this collateral structure.[37]

Among the characteristics of the fiduciary sale, two are of great importance for the widespread utilisation of this specific type of guarantee: the relative ease of foreclosure in an event of default (including the possibility for the creditor to perform an extrajudicial sale of the assets given in collateral) and the fact that assets given in the fiduciary sale would have special priorities and enhancements in insolvency and reorganisation proceedings involving the debtor.[38]

Creditors should be aware that proper formalisation of guarantees such as fiduciary sales is of utmost importance in Brazil to ensure the priorities and enhancements set forth in law. In this regard, fiduciary sales are perfected in writing, by means of a public or private document filed at the relevant office of the Registry of Deeds and Documents located in the debtor's domicile.[39] However, creditors tend to take a conservative stance and proceed with the registration in both the creditor's and debtor's place of business (in the case of different headquarters or multiple establishments). This additional measure is to ensure enforceability against third parties but will not affect the validity or effectiveness of the guarantee if not conducted.

There has been some controversy regarding the legitimacy of foreign financial institutions being the beneficiaries of fiduciary sale guarantees under the terms of Law 10931. The prevailing understanding is that foreign financial institutions can indeed be beneficiaries of such guarantees on the grounds that Brazilian law does not differentiate between foreign and local financial institutions in similar structures. If transactions with equal structure carried out by Brazilian financial institutions are deemed 'within the scope of financial and capital markets', the same treatment should be afforded to transactions carried out by foreign financial institutions facing Brazilian companies. This understanding has not yet been confirmed by the courts.[40]

ii Potential risks in an insolvency scenario

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

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

Priority of claims

In the event of liquidation,[41] the Brazilian Bankruptcy Law sets forth a ranking of claims to be paid in a waterfall model with the proceeds obtained from the sale of the debtor's assets. This ranking also applies to extrajudicial liquidation proceedings of financial institutions.

After payment of super priority claims and expenses – including labour-related claims of a salary nature maturing in the three months preceding the liquidation adjudication;-[42] expenses essential for the management of the bankruptcy estate; the realisation or payment of claims for restitution (e.g., creditors holding claims secured by a fiduciary sale have the right to repossess their collateral to sell it outside of the liquidation proceeding);

and payment of the post-petition claims (e.g., debtor-in-possession financings and the trustee's fees)[43] – the balance of the proceeds received as a result of the liquidation of assets must be used to pay the pre-petition claims, in accordance with the following order:

1. labour-related claims, limited to 150 minimum wages per creditor (amounts exceeding this cap are reclassified as unsecured claims), and occupational accident claims;
2. secured claims (secured by *in rem* guarantees such as mortgage and pledge) up to the value of the collateral;
3. tax claims, except for tax fines;
4. special privilege claims (defined in civil and commercial laws);
5. general privilege claims (defined in civil and commercial laws);
6. unsecured claims;
7. contractual penalties and monetary penalties for breach of criminal or administrative law, including tax law; and
8. subordinated claims.

i Second liens

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

ii Intercreditor agreements

Intercreditor agreements are common practice in Brazil, and there is little controversy about their enforceability and effectiveness. Even in highly complex insolvency situations involving syndicated facilities, courts tend to accept the validity of intercreditor provisions. However, the legal ranking of claims applicable to liquidation proceedings (indicated above) will not be amended to reflect the subordination set forth under intercreditor agreements. In this sense, if a group of unsecured creditors agree to a structural subordination under an intercreditor agreement, it is likely that under the liquidation proceeding all creditors will be paid in the same proportion in the liquidation proceeding and will have to make the necessary arrangements among themselves (e.g., through an agent) to reflect the subordination agreed upon under the intercreditor agreement.

Other issues concerning intercreditor agreements relate to:

1. correct and complete identification of the collateral enforceability mechanism in the intercreditor agreement, including sufficient granting of powers to agents acting on behalf of creditors; and
2.

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

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

Jurisdiction

i Choice of law and jurisdiction

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

In principle, the right of the parties to choose the governing law of agreements depends on the existence of a link between the underlying transaction to be performed and the law selected by the parties to govern their obligations.[44] A general limitation applies to the choice of law: the governing law should not violate Brazilian national sovereignty, public policy and good morals or ethics.

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

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

Nonetheless, the filing of a lawsuit before a foreign court does not preclude the Brazilian courts from judging the same case if:

1. the defendant, whatever its nationality, is domiciled in Brazil;
2. the obligation is to be performed in Brazil; or
3. the actions result from a fact that occurred or an act performed in Brazil.

Thus, in acquisition finance scenarios with obligations to be performed in Brazil and guarantees set up locally, Brazilian courts will always have concurrent jurisdiction.

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

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

1. the judgment fulfils all formalities required for its enforceability under the laws of the country where the judgment was issued;
2. the judgment was issued by a competent court;
3. the parties involved were duly summoned before the foreign court, which must comply with Brazilian Law if made in Brazil;
4. the judgment is final and not subject to appeal;
5. the judgment was legalised by a Brazilian consulate in the country in which the judgment was issued[45] and is accompanied by a certified translation into Portuguese; and
6. the judgment is not manifestly against national sovereignty, public policy and good morals or ethics.

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

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

ii Pre-enforcement procedures

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

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

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

Acquisitions of public companies

i Going-private transactions in Brazil

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

In this sense, noteworthy going-private transactions in the Brazilian market are usually 'elephant' deals conducted by large strategic players in specific situations.[46] Recent examples reflect the privatisation trend and include a number listed companies controlled by the federal and state governments, which following privatisation were delisted, such as Pernambuco's Companhia Energética do Pernambuco, Rio Grande do Sul's Companhia Estadual de Transmissão de Energia Elétrica and Companhia Estadual de Distribuição de Energia Elétrica.

Going-private transactions must follow specific requirements set forth by CVM Resolution 85 of 31 March 2022, which governs tender offers. Among the several types of tender offers, CVM Resolution 85 defines the 'going private tender offer' or 'delisting tender offer', prescribing a mandatory tender offer at fair price as a condition for cancelling the registration of a public company.

One issue that may come up relating to debt financing is the equitable treatment of shareholders in the context of a tender offer. Article 4, II of CVM Resolution 85 requires that minority shareholders are treated equally within an offer, including with respect to information on the company and the offeror. In the event that the offeror is obtaining acquisition finance from a financial institution that is also a minority shareholder or has an affiliate that is a minority shareholder, this should not entail additional advantages to this shareholder-lender when compared with the others (which may be difficult to sustain given that naturally, as a lender, the minority shareholder will have better and more complete information than the other minority shareholders). To minimise risks of questioning, the transaction should be conducted at arm's length and the maximum amount of information made available to the lender should also be available in the tender offer prospectus.

ii Squeeze-outs under Brazilian law

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

Along with the additional protection afforded to minority shareholders, which requires a tender offer at fair price and the acceptance (or consent) of more than two-thirds of the minority shareholders registered to participate in a special auction as a condition for the delisting, the new legislation permits a squeeze-out in the event that the tender offer is successful (i.e., the company is delisted) and the controlling shareholder holds more than 95 per cent of the company's share capital after the offer.[47]

One important concern that arises in squeeze-out transactions relates to the inability of the offeror to reach the minimum 95 per cent threshold during the delisting auction. In this case, some alternatives are available to the offeror: it can obtain the 95 per cent threshold in the three-month period following the auction (the put-right period)[48] or it can privately negotiate with the minority shareholders.

Outlook and conclusions

Having undergone a second impeachment process in 30 years since redemocratisation, Brazilian institutions have displayed a notable resistance. Although the roller coaster of economic projections, possibilities for accelerated fiscal adjustment and urgent reforms have boosted the cautious optimism generated by the current economic cabinet, which is filled with well-known faces from the local financial markets.

A number of market-orientated reforms passed over recent decades have consolidated a more investor-friendly and sound regulatory market infrastructure, including in the acquisition finance market, and other reforms, especially the long-awaited tax reform, are currently under discussion in the Brazilian Congress. This has helped to improve foreign investment and further diversify the country's investor base, helping Brazil to consolidate its economy's position within the top 10 in the world. The warnings were everywhere that the increased level of government interference in the economy, including through the massive growth of lending in public sector banks and price controls, could snowball into a major crisis, and that is precisely what happened.[49] Certain market-orientated decisions were made during the tenure of the liberal federal government that left office in 2022. As a part of a toolkit of legislative actions to further open the economy and decrease interference, the Brazilian Congress enacted the Declaration of Economic Freedom Rights. Announced as an effort to cut red tape in the Brazilian economy, Law 13,874 of 20 September 2019 put in place a set of principles aimed at assuring the free market status of the country's economy. The declaration has also changed specific legal provisions to bring a forthright response and solution to the chronic problems business entities in Brazil grapple with routinely. Despite the change of government in the beginning of 2023, with its fair share of political turmoil, the market had already priced the political instability, with some starting to argue that there is an interesting decoupling phenomenon in place: the economy will recover regardless of the chaotic nature of the political arena.

From the legal and regulatory standpoints, revamped due diligence and contractual terms, along with discussions around limitation of liability for acquisitions of assets from companies involved in corruption scandals, are hot topics in the legal community. Also the economic crisis is putting the relatively young Bankruptcy Law into a forced stress test,

with a number of restructuring procedures involving enormous companies (such as the judicial reorganisation of Oi, one of the largest telecoms providers in the country). For legal practitioners, the increasing stream of M&A opportunities within these procedures will be on the radar, as the market experiences a spike in financial sponsors focused on mandates for 'special situations' opportunities. From a tax standpoint, a favourable resolution of the ongoing tax controversy on the deductibility of acquisition-induced leverage may provide additional transparency and incentives for leveraged acquisitions in the Brazilian market.

Endnotes

1 Fernando R de Almeida Prado and Fernando M Del Nero Gomes are partners and Antonio Siqueira Filho is an associate at Pinheiro Neto Advogados. The authors would like to thank the following colleagues for their suggestions for and comments on this chapter: Bruno Balduccini, Caio Ferreira Silva, André Marques, Giancarlo Matarazzo, Fernando Zorzo and Marcello Portes da Silveira Lobo. ^ Back to section

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

3 Even though M&A activity slowed in 2022 amid global and local macroeconomic scenarios, overall deal values are comparable to pre-pandemic levels. See 'M&A in Brazil: A Nation Prepares for Changes', https://www.bain.com/insights/brazil-m-and-a-report-2023. ^ Back to section

4 Examples of locally led consolidation include sectors such as telecoms (Oi-Brasil Telecom), education services (the*Anhanguera/Kroton* and *Kroton/Estácio* mergers were the most prominent among a high number of deals), retail (*Casas Bahia/Pão de Açúcar, Pão de Açúcar/Ponto Frio* and *Ricardo Eletro/Insinuante*), market infrastructure (CETIP and BM&F Bovespa merged to create B3), banking (Bradesco acquired HSBC Brazil and Itaú acquired Citibank Brazil and XP Investimentos retail unit in the most recent wave of consolidations), cosmetics (Brazilian company Natura acquired Avon), car rental (Localiza and Unidas) and healthcare (the Intermédica and Hapvida mega-merger). ^ Back to section

5 The participation of private equity sponsors reached approximately 30 per cent of the announced deals in 2014 and 2015. In 2016, this number diminished to approximately 20 per cent and remained around that range for 2017 and 2018. Important signs of the consolidation of private equity players in Brazil are recent historical fundraising for Brazil by major players in the private equity space, such as Advent's US$2.1 billion and Patria's US$1.75 billion fundraising in 2014. In 2016, sponsors were back to successful fundraising rounds: HIG announced in April a round of US$740 million focused on middle market acquisitions. Good news is also coming from the venture capital market, which made strides in Brazil recently, a truly market-changer in 2021 that lost steam with the bear market of 2022 and 2023. ^ Back to section

6 On 21 September 2023, during the latest meeting of the National Monetary Council, the SELIC rate was set at 12.75 per cent. ^ Back to section

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

8 Noteworthy sponsor-backed deals with LBO-like features include Mubadala's acquisition of Mataripe oil refinery from oil tycoon Petrobras, Suzano's acquisition of Fibria in the pulp industry, Kroton's acquisition of Somos in the education sector and Enel's acquisition of Eletropaulo in the electric power industry. ^ Back to section

9 Taking BNDES out of the equation, the four largest banks in Brazil concentrate nearly 80 per cent of the total assets in the system, and all of them are local: Banco do Brasil, Caixa, Itaú Unibanco and Bradesco. Santander, the fifth in the list, is the only foreign player with a national presence. ^ Back to section

10 The participation of BNDES in the total credit available in the Brazilian market reached 23 per cent in December 2014, but it is more illuminating to analyse its total assets evolution in the past 10 years: in 2004 assets totalled 164 billion reais, while in 2015 this reached 931 billion reais (compound annual growth rate of 16 per cent in the period): https://www.bndes.gov.br/arquivos/ri/series-historicas-bndes.xlsx. In 2016, under new administration, total assets dropped to 876 billion reais, a trend which continued until 2021, with total assets dropping to 737 billion reais. BNDES financing follows strict regulations and guidelines and can be obtained for specific sectors falling under pre-approved special credit lines. The centre-stage role taken by BNDES in acquisition finance is part of a broader story. The market has been closely watching the Brazilian public sector banks grow their loan books exponentially, while private players took a more cautious approach (to take more recent numbers, while private banks credit portfolio rose 5.4 per cent from April 2014 to April 2015, public sector banks rose its portfolio by 15.5 per cent). By March 2015, the public banks' outstanding credit rose to 54 per cent of the total (Caixa Econômica Federal, Banco do Brasil and BNDES – all three are government-controlled – being the top three banks in total credit in Brazil). Over the past few years, economists and multilateral bodies (including the International Monetary Fund (IMF)) have voiced their concerns about this situation. Besides an increased participation of the public sector in the economy, experts feared that a credit bubble was being sponsored by the government, creating difficulties for public banks to maintain healthy capital ratios (mainly in the face of Basel III) and delinquency levels. Several specialised publications have been covering this trend; for example, see 'Brazil: Warning over public-sector bank lending', *The Economist*, www.eiu.com/industry/article/1351100719/brazil-warning-over-public-sector-bank-lending/2013-10-23. Recent corruption scandals involving JBS and bribes paid for success to massive government banks' lending shows these concerns were spot on. ^ Back to section

11 Among those deals backed by BNDES financing, we highlight the mergers that created Brasil Foods (BRF) and Fibria, in addition to the massive lines provided for acquisitions of JBS group, including outside Brazil. ^ Back to section

12 The average interest rates charged by financial institutions help to understand this scenario: for the entire market, the August 2023 average interest rates were 43.5 per cent per annum. For corporates, the August 2023 average rate was 22.6 per cent per annum. In the category of directed credit (i.e., pre-approved lines, which comprise rural, real estate and all BNDES loans), this rate fell to 11.3 per cent per annum in the same period. See the Central Bank's monetary policy and interest rates note at https://www.bcb.gov.br/content/estatisticas/hist_estatisticasmonetariascredito/202309_Tabelas_de_estatisticas_monetarias_e_de_credito.xlsx. ^ Back to section

13 Recent divestitures of BNDES include the sale of its equity interest in Petrobras, mining company Vale, pulp and paper companies Suzano and Fibria, electric power distributor Rede Energia and tech company Linx. ^ Back to section

14 Brazilian companies raised 120 billion reais in the capital markets in the first semester of 2020. See 'Crédito Privado: oportunidade e estímulo a economia', *Valor Econômico*, 15 September 2020. ^ Back to section

15 'The lack of a developed market for private debt continues to be a barrier for big leverage buy-outs. Ninety per cent of funds surveyed said that on average deals are done with 25 per cent debt or less' (see www.insead.edu/sites/default/files/assets/dept/centres/gpei/docs/insead-pwc-brazilian-pe-a-new-direction-2014.pdf). The high financing costs offer less margin to manoeuvre for Brazilian companies that are targets of LBOs. If operating problems occur in the months following an acquisition, while leverage levels are still high, refinancing costs are prohibitive. There are a few precedents of tumultuous refinancing of leveraged companies while still held by the acquiring sponsors in Brazil. ^ Back to section

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

17 Note that this concern does not apply to foreign entities that offer credit to Brazilian entities. ^ Back to section

18 CMN Resolution 2686 of 27 January 2000. ^ Back to section

19 CMN Resolution 2836 of 31 May 2001. ^ Back to section

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

21 'The most popular private equity vehicle in the Brazilian M&A practice is by far the FIP, whose structure bears some similarity to the partnership fund model generally adopted in the US and in Europe. CVM introduced FIPs to Brazil through Rule No. 391 (CVM Rule 391/03), issued on 16 July 2003. By laying down the legal and regulatory grounds for the establishment of an investment conduit that local and foreign investors formerly lacked when sponsoring private equity ventures in Brazil, CVM Rule 391/03 largely contributed to a rapid expansion of FIPs in M&A deals, which has been further expanded after enactment of CVM Rule No. 578 of 30 August 2016 (which revoked and replaced CVM Rule 391/03). More importantly, investments and exit strategies successfully implemented by FIPs since 2004 created an encouraging track record that helped Brazilian private equity-backed M&A transactions achieve high priority on the agendas of institutional investors.' José Carlos Meirelles and Caio Ferreira Silva, 'Brazilian Private Equity Funds FIPs: A DNA Change in Brazilian M&A Deals',*Harvard Business and Law Review* online, Volume 4, 2013. ^ Back to section

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

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

24 Notably, OAS, a major contractor involved in bribery scandals, sought court protection under the Brazilian Bankruptcy Law. ^ Back to section

25 Law 11101 of 9 February 2005. ^ Back to section

26 'Sale and purchase transactions in the context of debt restructuring may offer certain protections against customary succession risks, provided that the applicable requirements are met. On the other hand, indemnities for other matters may not be on the table for a variety of reasons, including the multiplicity of stakeholders. Such transactions may require negotiation with, and acceptance of the deal by, the seller, its creditors, courts and the judicial administrator, just to name a few. Depending on the relevant industry, the regulatory agency or granting authority may also play an important role as changes of control are usually subject to approval and compliance with financial, technical and legal qualifications by the buyer. So, what is left in terms of protections for the buyer? The due diligence should be even more thorough and detailed than usual, with a special focus on compliance matters, not only with respect to the target company, but also the seller, its corporate group and other companies involved in the business. Security or collateral arrangements should also play an important role, considering the difficulty and cost associated with obtaining bank guarantees or M&A insurance in the current market.' Marcello Portes da Silveira Lobo in 'Mergers and acquisitions in Brazil – challenges and opportunities for buyers',-*Financier*, July 2016. ^ Back to section

27 The Equator Principles were strictly observed by some financial institutions that participated in controversial project finance structures for the construction of mega hydropower plants in the Amazon region (Jirau, Santo Antonio and Belo Monte plants). ^ Back to section

28 CMN Resolution 4327 of 25 April 2014, later revoked and replaced by CMN Resolution 4945 of 15 September 2021. ^ Back to section

29 'In order to comply with the Resolution, the institutions shall maintain an adequate governance structure for implementation, monitoring and effectiveness of the PRSA, including by means of the – optional – creation of a social and environmental responsibility committee to this end. The institutions shall establish an action plan for implementation of the PRSA, which plan, together with the PRSA policy, shall be approved by the Executive Board and, if any, by the Board of Directors of such institutions. Each institution shall appoint an officer responsible for compliance with the PRSA, and provide for the internal and external disclosure of such policy.' Werner Grau, Maria Christina Gueorguiev and Rosine Kadamani,*Biblioteca Informa Newsletter*, Pinheiro Neto Advogados, 24 June 2014. ^ Back to section

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

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

32 See Giancarlo Matarazzo and Rubens Biselli's article on the matter in*Revista Dialética de Direito Tributário* No. 228. ^ Back to section

33 Law 11727 of 23 June 2008. ^ Back to section

34 Originally by CVM Instruction No. 565 of 15 June 2015, which amended and revoked provisions of CVM Instruction No. 319 of 3 December 1999, dealing with the topic of mergers and consolidations of public companies, and now by CVM Resolution No. 78 of 29 March 2022, which revoked and replaced both of the rules detailed above. ^ Back to section

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

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

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

38 Compared with other types of collateral, such as pledges, mortgages and other*in rem* guarantees, this is an important advantage. In this sense, while claims secured by pledges, mortgages and other similar structures have certain priorities in liquidation regimes, beneficiaries of fiduciary sales may foreclose on or request the restitution of the assets granted as collateral and sell these assets outside of the liquidation proceeding. Likewise, in a judicial reorganisation proceeding (similar to a Chapter 11 proceeding), holders of claims secured by fiduciary sales are not subject to the effects of the reorganisation (e.g., not subject to the terms of the reorganisation plan) and may foreclose on the collateral at any time (apart from when the collateral is essential to the debtor's business – in this circumstance, the foreclosure would be stayed during the 180-day stay period). Courts have generally observed and consolidated this priority of the fiduciary sale. ^ Back to section

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

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

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

42 Limited to five minimum wages per employee. ^ Back to section

43 Debtor-in-possession (DIP) financing is a novelty in the Brazilian legal system (introduced by the Bankruptcy Law in 2005) and does not have the same enhancements of the DIP financing under the US Bankruptcy Code. ^ Back to section

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

45 Except where there is a bilateral agreement with the relevant country to waive an authentication by the Brazilian consulate or if apostilled when the relevant country is signatory to the Hague Convention of 5 October 1961 Abolishing the Requirement of Legalisation for Foreign Public Documents. ^ Back to section

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

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

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

49 'During the past decade, Brazil has achieved substantial progress in capital market development. The menu of available financial instruments has been expanded, market infrastructure has been reformed and strengthened, and a diversified investor base has been built. This was a high-priority agenda for the authorities, and the reforms were introduced in close cooperation with market participants. Nonetheless, challenges remain and the continued development process will need careful management. Despite the country's great potential (e.g., large size of economy, sound fiscal management, and large mutual fund industry), Brazil's capital markets are still facing a number of challenges. These include still prevalent short-term indexation, investors' risk aversion to long-term fixed rate bonds, still low liquidity in the secondary market, and managing the role of BNDES. A shift to a lower yield curve environment should continue to gradually take place. But further progress will require continued policy effort to assure macro stability and financial sector reforms to promote the development of longer-term private finance. It will also require close monitoring, to avoid a build-up of risks that could be engendered by the search for yield as the yield curve shifts down.' Joonkyu Park, 'Brazil's Capital Market: Current Status and Issues for Further Development', IMF Working Paper, September 2012. ^ Back to section

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Introduction

The complex geopolitical situation nowadays affects the Bulgarian financial sector. Besides the overlapping economic, energy and health crises internationally, the domestic political environment in Bulgaria has also been quite intense. Following a long political instability period including five snap parliamentary elections in the past couple of years, however, as of June 2023 Bulgaria has a broad coalition government supported by a large parliamentary majority.[2]

Despite the Russia–Ukraine conflict fuelling inflation, there has been a substantial rise in M&A activity, including acquisition finance, since the end of 2022.

The businesses that continue to generate interest from investors are in the areas of energy, telecommunications, TV media and IT services. A notable new trend in acquisition financing with respect to renewable energy projects is the use of green bonds. This is driven by the entry to the market of foreign lenders structured as alternative investment funds that are prohibited from extending classic loans but may invest in bonds issued by corporate borrowers.

Regarding existing large-scale loans involving Bulgarian obligors, although Bulgarian authorities were slow in implementing measures to help companies affected by the pandemic and, more recently, by the increase of energy prices where measures, once available, turned out to be insufficient, in the past few years there was no visible increase in bankruptcy proceedings against Bulgarian obligors. Because of flaws in the Bulgarian insolvency procedure, creditors usually prefer to find other mechanisms to collect their debts. It is also possible for a surge in insolvencies to appear only several years after the start of the pandemic. For example, the effects of the 2008 financial crisis were mostly felt in the period between 2012 and 2014, when there was a two-to-threefold increase in insolvency proceedings compared with previous years.

Until recently, the temporary bank loans moratorium and the long-standing policy of the ECB and central banks in various Member States (including in Bulgaria) to keep interest rates low were the major differences compared to the financial crisis in 2008. However, the last Bulgarian covid-related moratoriums expired on 31 December 2021 and the change in the EU central banks' policies regarding interest rates was recently reflected in Bulgaria where, on 1 October 2022, the Bulgarian national bank increased the base interest rate to 0.49 per cent per annum, thus exceeding zero per cent for the first time since 2016. Further increase in interest rates may result in loan repayment instalments becoming exceedingly burdensome, although we are still to register these effects. Hence, it is difficult to say whether we will see decreasing M&A activity and a surge in the restructuring of existing loans, or whether M&A activity will recover to its pre-covid level.

Year in review

Bulgaria was in a situation of long political instability until recently and the situation was further exacerbated by the continuing economic hardships following the Russia–Ukraine conflict. After five snap elections in the past couple of years, however, since June 2023 Bulgaria has enjoyed a broad coalition government. Many crucial laws that were delayed due to the lack of a stable parliament are now being adopted.

On 1 August 2023, the EU restructuring or second chance Directive (EU) 2019/1023 was transposed in Bulgaria by fully introducing its mechanism into the existing Bulgarian pre-insolvency restructuring regime. Alongside this harmonisation, the 'likelihood of insolvency' criterion as a prerequisite for the restructuring application was amended. It is now defined as the debtor's expected inability to make payments (as opposed to the former regime when only certain payments were relevant) based on their maturities over the next 12 months (as opposed to six months, previously). The six-month threshold prior to the new law proved to be too short, as applications were submitted too late, and the courts were regularly faced with an actual insolvency as opposed to a likelihood of insolvency when deciding on them.

Another novelty is the express obligation of the debtor's management to take steps for restructuring should there be likelihood of insolvency. Although this is not defined expressly as an obligation to file for restructuring in many cases, such filing would be the only possibility to avoid insolvency. So far, the number of applications for restructuring has been negligible, with almost none being upheld and followed by actual restructuring proceedings. As a result of the new obligation this may change, and management bodies would be well advised to have an action plan in place now to identify in a timely manner the occurrence of likelihood of insolvency and to take restructuring steps to comply with the new statutory requirement.

Regulatory and tax matters

i Licensing or registration of lenders

Under Bulgarian law, lending money on a commercial basis may only be performed by banks licensed by the Bulgarian National Bank (BNB) and financial institutions registered with the BNB. The major difference between the two types of lenders is that banks take deposits while financial institutions extend loans using their own resources.

Banks licensed in another EEA Member State may provide lending in Bulgaria under the EU freedom to provide services – following a notification to the BNB by their home Member State regulator, or under the freedom of establishment by opening a branch in Bulgaria. Banks from outside the EEA should obtain a licence from the BNB to exercise bank activities via a branch before lending in Bulgaria.

Non-banking financial institutions from another EEA Member State may provide loans in Bulgaria following a notification to the BNB by their home Member State regulator under Article 34 of Directive 2013/36/EU. Non-banking financial institutions seated outside the EEA may not provide loans in Bulgaria. As mentioned, there is also increased activity by entities structured as alternative investment funds under Directive 2011/61/EU to extend financing by investing in privately placed bonds issued by the borrower. Regarding the Bulgarian implications of loans extension by foreign lenders, there is no official guidance from the BNB as to the meaning of 'providing lending activities in Bulgaria', but we believe this occurs when foreign lenders, even if they do not have a physical presence in Bulgaria, target the Bulgarian market to offer lending activities repeatedly and on a commercial basis to borrowers in Bulgaria. There is no restriction on the freedom to

provide requested services (i.e., the right of persons and entities domiciled in Bulgaria to request the lending services of a foreign entity on their own initiative). As this is a fairly common scenario in cross-border acquisition financings, it may be wise to have in place a suitable reverse-solicitation clause in the finance documents. This is particularly relevant for non-EU lenders (including from the United Kingdom) as well as for EU lenders whose volume of Bulgarian operations may raise concerns as to whether they act under the freedom to provide services or should rather be classified as acting under the freedom of establishment (i.e., requiring the opening of a local Bulgarian branch). Both types of foreign lenders would benefit from structuring their activities under the unrestricted freedom to provide requested services by Bulgarian lenders via reverse solicitation arrangements.

ii Sanctions, anti-corruption and money laundering

As an EU Member State, Bulgaria has transposed the relevant EU legislative acts with respect to anti-money laundering (AML) and counter-terrorist financing (CFT), and applies the sanctions imposed at EU level. The local Act on the Measures Against Money Laundering and the Act on the Measures Against the Financing of Terrorism provide for extensive due diligence to be conducted by banks on borrowers before entering into a loan agreement. Potential borrowers are subject to know-your-customer checks that must identify their representatives, direct and indirect shareholders (including if there are any offshore companies among them), beneficial owners, potential politically exposed persons and source of funds. As banks tend to be very cautious in avoiding breach of the above laws, recently their AML and CFT policies have often been stricter than the statutory requirements.

The risks associated with sanctions and potential breach of anti-corruption, terrorist financing and AML laws may be further contractually mitigated by appropriate representations and warranties in the finance documents.

Regarding the sanctions for terrorism financing on local level, the Council of Ministers is responsible for modifying the list of persons to be affected by the measures under the Bulgarian Act on the Measures Against the Financing of Terrorism. The most recent amendment to that list was made on 8 September 2022.[3]

iii Tax issues

In general, there is withholding tax paid on interest payments under a loan in Bulgaria. If there is a double tax treaty between Bulgaria and the respective foreign country, the rules in that treaty must be followed so withholding tax on interest payments may or may not be due in accordance with such treaties.

As far as corporate income tax is concerned, interest expenses are deductible for corporate income tax purposes in Bulgaria. Bulgaria has tax treaties with many foreign countries and the specific treaty must be checked to ascertain if interest expenses are deductible for corporate income tax purposes (as a rule, they are deductible). Furthermore, there are rules for thin capitalisation whereby a certain portion of the interest expenses may not be recognised for corporate income tax purposes. Thin capitalisation, in turn, does not apply to interest payments on financial leases and bank loans, except where the parties are related or the lease or loan is guaranteed or secured by, or is extended on the instruction of, a

related party. Lastly, since 2019 an interest deduction limitation rule has been applicable, whereby exceeding borrowing costs would not be recognised for corporate tax purposes for the current year. 'Borrowing costs' mean the costs or amounts recognised for tax purposes that lead to a reduction in the financial tax result, including all interest expenses on any type of debt, other expenses and amounts, economic equivalent to interest, as well as other costs and amounts incurred in connection with fundraising, expenses and amounts for penalty interest for late payments and contractual penalties that are not related to financing. 'Excess of borrowing costs' is the amount by which the total amount of the costs of loans exceeds the total amount recognised for tax purposes revenues or amounts that lead to an increase in the financial tax result, as well as other income or amounts economically equivalent to interest. This interest deduction limitation rule is not applicable when the excess of borrowing costs for the current year does not exceed €3 million.

As far as tax reporting is concerned, provided that lenders are not subject to Bulgarian corporate income tax (including capital gains) derived from loans to Bulgarian obligors, there are no tax reporting issues for lenders as a result of having Bulgarian obligors located in Bulgaria.

In general, there is no stamp duty chargeable in Bulgaria.

Security and guarantees

i Guarantees

Regarding guarantees, Bulgarian obligors are normally required to provide guarantees under the law governing the loan agreement.

On certain occasions, however, non-EEA lenders under non-Bulgarian-governed loans require that a Bulgarian obligor provide a guarantee governed by Bulgarian law and subject to the jurisdiction of Bulgarian courts. This is primarily to avoid potential problems with the recognition of non-EEA court judgments. In these cases, the specific rules in Bulgaria about surety and joint and several liability may require specific structuring of a Bulgarian guarantee to repay a loan under a foreign system of law.

In both cases, certain limitation language is normally considered.

ii Limitation language

The restrictions under Directive 2012/30/EU, including the prohibition on financial assistance, are applicable only to joint-stock companies in Bulgaria (similar to the German *Aktiengesellschaft*). Any type of guarantee or provision of security interests by these companies for the acquisition of their own shares is invalid. As the other widely used type of corporate entity in Bulgaria – the limited liability company (similar to the German *Gesellschaft mit beschränkter Haftung*) is not mentioned – neither in Directive 2012/30/EU, nor in the Bulgarian transposition legislation, the dominant view among practitioners is that the financial assistance rules do not apply to such entities.

However, regarding limited liability companies, there are express capital preservation rules (whereby shareholders are entitled only to dividends and liquidation quotas), certain

casuistic avoidance rules for transactions detrimental to the other creditors and for transactions at undervalue (whereby transactions favouring related parties may be caught), as well as tax law requirements for arm's-length arrangements to transactions in favour of related parties. Therefore, it may be prudent to insert certain representations and warranties and some specific declaratory provisions to minimise possible risks concerning guarantees or security interests for the acquisition of a limited liability company's own shares.

Other limitation language that it is wise to consider using in financial documents is to minimise the risk of the respective guarantor becoming automatically overindebted as a result of guaranteeing a loan to its parent.

iii Security

Typically, the security package under acquisition financings contains a pledge over shares, a non-possessory floating charge pledge over the whole enterprise or over a limited pool of assets of the Bulgarian obligor, as well as a non-possessory fixed charge pledge over certain valuable assets.

The pledge over shares in different types of corporate entities is governed by rules imposing different formalities, that is, the pledge over:

1. shares or quotas in a limited liability company must be documented in a notarised agreement and must be registered with the Commercial Register;
2. materialised shares in a joint stock company takes place by endorsement and delivery of the paper materialising the shares; and
3. dematerialised shares in a joint stock company must be documented in a notarised agreement and must be registered with the Central Depository (where dematerialised shares are kept as electronic book entries).

As a market standard, the pledge over shares is combined with a pledge over the dividends and other receivables stemming from the shares where the respective rules for a possessory or non-possessory receivables pledge apply as per the parties' arrangements.

Another typical security in large-scale financings is the pledge over the whole enterprise of the Bulgarian obligor, which is similar to the English floating charge crystallising over the particular assets within the enterprise on the date when commencement of enforcement is registered (in the same registry where the pledge is registered initially by way of establishment). This pledge must be documented in a notarised agreement and must be registered with the Commercial Register. As an element of the enterprise pledge, a fixed charge may be agreed in the same agreement – over particular valuable assets such as movables, receivables and real estate properties requiring additional secondary registration in a public register that differs for the different assets. Following a secondary registration, the pledgor may not deal with the fixed charge assets. Notably, as the stand-alone mortgage over real estate property is expensive in large-scale financings (as the registration fee is a proportion of the secured obligation without a cap), banks normally require their corporate borrowers to establish security interest over real estate property only as an element of the enterprise pledge.

Less often lenders will require a non-possessory pledge over a pool of certain types of assets (rather than the whole enterprise), usually dictated by the specific business of the pledgor or non-possessory stand-alone pledge over particular assets – dictated by the possibility of using a different enforcement route (as opposed to the fixed charge over the same assets as a part of the enterprise pledge).

Financial collateral under Directive 2002/47/EC has been transposed in Bulgaria in a manner where it may be used to secure any obligation that may be performed by payment of money or delivery of securities, thus potentially covering loan arrangements as well. However, the requirement for transfer of possession or control may be inappropriate under loan arrangements where the borrower normally retains possession of the asset to use it and generate income, thus repaying the loan. The only type of asset suitable to be used as financial collateral in large-scale acquisition financings seems to be a share in joint-stock companies. However, Directive 2002/47/EC was transposed in Bulgaria with a specific nationality restriction on the eligible counterparties, which albeit not very clearly may be construed as requiring that the financial institutions (to be eligible counterparties under financial collateral) should be from EEA Member States. Therefore, banks and other financial institutions from states such as Japan, the United Kingdom and the United States may be prejudiced to enjoy the benefits of being eligible counterparties under financial collateral when dealing with Bulgarian borrowers.

iv Holding security interests for multiple lenders

Typically, under foreign law-syndicated loans a parallel debt for a security agent is agreed to ensure that the security agent validly holds a security interest in favour of multiple lenders. As long as the concept is valid under the respective foreign law governing the loan agreement, it should be respected by Bulgarian courts as well. There has been no problem so far with registering a security agent acting under a parallel debt as secured creditor in the registries where security interests are established or with registering out-of-court enforcement in Bulgaria by such agent. Furthermore, to the best of our knowledge there has never been a dispute before a court where Bulgarian courts refused to apply the law governing a parallel debt arrangement as contravening Bulgarian public policy.

On the contrary, in Bulgaria there is a legal concept very similar to the English 'parallel debt' called 'contractual joint creditorship' where each creditor may claim the whole debt although the creditor did not provide it or provided only a portion of the consideration for it. The only difference from the English parallel debt is that no new or parallel debt is created but all or some of the lenders agree to be joint creditors for a single debt via contractual arrangement (without creating a new or parallel one). Furthermore, there are specific cases where Bulgarian law expressly permits a person to take security interests without being a lender at all (similar to the English parallel debt) as:

1. financial collateral, under the EU Financial Collateral Directive as transposed in Bulgaria; and
2. when security is provided for bonds (in favour of a bonds trustee) under the Public Offering of Securities Act.

Given that these specific cases under Bulgarian substantive law recognise a holder of security interests on behalf of multiple lenders, who provided no underlying loan, arguably the English parallel debt concept should not be manifestly contrary to Bulgarian public policy.

However, owing to the lack of a benchmark piece of Bulgarian case law (as opposed to France, Poland and, recently, the Czech Republic) expressly upholding the English parallel debt, some banks have been very cautious and, as a result, it is common for all lenders in a syndicate to take security in their own names in Bulgaria. There is no technical obstacle under Bulgarian law when registering security interests to list more than one person as a secured creditor and to describe the secured obligation as encompassing different claims, thus creating a first-ranking security in relation to multiple claims of lenders. Problems may arise, however, when it comes to amendments to the pledge agreement, as well as assignment or enforcement of claims secured in this manner, as all foreign lenders registered as secured creditors have to provide formal powers of attorney to Bulgarian lawyers, as well as some declarations and corporate certificates on each occasion to make the respective amendment, assignment or enforcement effective, including via registrations in local registries. To overcome such problems, it seems reasonable, in addition to having all members of a bank syndicate registered as holders of security in Bulgaria, to stipulate cumulatively that one of these creditors (a security agent) acts as a foreign law parallel debt creditor under each secured obligation and to register that security agent as a secured creditor not only for that creditor's claims but for the claims of all remaining creditors as well. Furthermore, a power of attorney should be granted to the security agent to execute or perfect any amendments to the pledge agreement, as well as to assign and enforce claims, avoiding a huge amount of paperwork in each case.

Priority of claims

The Bulgarian Obligations and Contracts Act establishes the ranking of claims over a debtor's property in the case of a court-bailiff enforcement procedure as follows (where creditors from each single line are satisfied proportionately and, upon their full satisfaction, creditors from the consecutive line are to be satisfied with the remaining part of the property):

1. claims on costs for attachments or enforcement procedures as well as for certain avoidance claims – over the value of the property for which these have been made;
2. state claims on taxes for certain properties or motor vehicles – over the value of that property or vehicle, as well as claims on concession payments, interests and penalties under concession contracts;
3. claims secured by a pledge or mortgage – over the value of the pledged or mortgaged properties;
4. claims for which a right of retention is exercised – over the value of the retained property, where if such a claim is over costs for maintenance or improvement of the retained property, it must be satisfied before the claims under item (c);
5. employees' claims under employment relationships and allowance claims; and
6. state claims other than those for fines or penalties.

In the case of an insolvency proceeding, the following special ranking of claims applies:

1. claims, secured by a pledge or mortgage or attachment – on the amount after realisation of the security asset;
2. claims for which a right of retention is exercised – on the amount or value of the retained property;
3. expenses for the insolvency proceeding;
4. claims under employment relationships existing before the date of the judgment opening the insolvency proceedings;
5. allowances due by the debtor to third parties by operation of law;
6. public law claims of the state or municipality such as taxes, customs duties, fees, mandatory social security contributions and others existing before the date of the judgment opening the insolvency proceedings;
7. claims existing before the date of the judgment opening the insolvency proceedings that have not been paid on their maturity date;
8. any remaining unsecured claims existing before the date of the judgment opening the insolvency proceedings;
9. a legal or contractual interest under unsecured claims, due and payable after the date of the judgment opening the insolvency proceedings;
10. claims under credits extended to the debtor by a shareholder;
11. claims under gratuitous transaction; and
12. creditors' expenses related to their involvement in the insolvency proceedings.

If the proceeds from turning the assets into cash in insolvency are not sufficient to satisfy all creditors within a certain rank, they are distributed on a pro rata basis.

The commencement of insolvency proceedings against a pledgor does not affect the enforcement of a registered pledge upon the pledged assets if the enforcement started before the opening of insolvency proceedings and if the collateral is identifiable within the debtor's estate. In addition, the commencement of insolvency proceedings against a debtor does not affect the enforcement proceedings of public debts if the enforcement started before the decision to open the insolvency proceedings.

Jurisdiction

As a preliminary note, apart from the private international law regulations that Bulgaria applies as a member of the European Union, it has the Private International Law Code from 2005 whose rules follow the private international law codifications of the major EU continental jurisdictions (mainly Belgium) and the EU regulations existing at the time of the adoption of the code.

The possibility for foreign lenders to have a valid choice of court in arrangements with Bulgarian obligors, as well as the recognition and enforcement of foreign judgments in Bulgaria, depends on where the lender is from – when it concerns the validity of the

jurisdictional agreement – and on the nationality of the court that rendered a judgment – when it concerns the recognition and enforcement of foreign judgments in Bulgaria. For counterparties from the European Union, exclusive and non-exclusive choice of court as well as recognition and enforcement without an exequatur procedure are permitted under the conditions and limitations of Regulation (EU) No. 1215/2012 of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (the Brussels I Regulation Recast).

For counterparties from other EEA countries (Iceland, Norway and Switzerland), the Lugano Convention on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters applies. In particular, Bulgaria will apply the Lugano Convention when a court in a Lugano Convention country (that is not an EU Member State) is chosen, and when the recognition and enforcement of a judgment originating from a Lugano Convention country (that is not an EU Member State) is being sought in Bulgaria. The rules of this convention are substantially similar to the Brussels I Regulation No. 44/2001 (repealed and replaced by the Brussels I Regulation Recast). The most notable differences under the Lugano Convention – as compared with the Brussels I Regulation Recast – are that recognition and enforcement in the former case is subject to an exequatur procedure (albeit a simple one) and choice-of-court agreements in the former case are not immune to 'torpedo' actions.

For non-EEA lenders from countries that are party to the Hague Convention of 30 June 2005 on Choice of Court Agreements, most notably UK lenders, the rules in that Convention apply (though they are only relevant to exclusive choice of court). The Hague Convention also contains rules relevant for the recognition and enforcement of judgments rendered by courts that have been chosen in accordance with its rules, subject to an exequatur procedure.

The recognition and enforcement of judgments rendered by other countries (non-EU countries, non-EEA countries and non-Hague Convention countries) is subject to a full exequatur procedure governed by the Bulgarian Private International Law Code. Choice-of-court agreements in favour of the courts of such third countries should be considered valid for the purposes of the recognition and enforcement of foreign court judgments to the extent they do not overstep the exclusive jurisdiction of a Bulgarian court and do not violate Bulgarian public policy. On the other hand, if the choice of court in favour of the courts of third countries is assessed when a Bulgarian court is determining its own jurisdictional competence to hear a dispute, it is not certain whether a Bulgarian court will uphold the choice if it is competent to hear the case on a jurisdictional ground under the Brussels I Regulation Recast and has been seized on the matter.

Bulgaria is a party to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards signed in New York on 10 June 1958 (the New York Convention) and Bulgarian courts uphold arbitration agreements under the conditions of the New York Convention to the extent that the underlying dispute involves a proprietary claim or a matter that can be resolved by settlement under Bulgarian law. A foreign arbitral award rendered in a contracting state to the New York Convention is recognised and enforced in Bulgaria under the conditions of the Convention, subject to an exequatur procedure.

Acquisitions of public companies

Mergers (including takeovers) and demergers (spin-offs and splits), share transfers and business (going-concern) transfers in Bulgaria are regulated by the Bulgarian Commerce Act. However, where the target is a public company, the specific rules set forth in the Bulgarian Public Offering of Securities Act (POSA) must be observed. Furthermore, takeover bids with respect to public companies are extensively regulated under Ordinance No. 13/2003 enacted by the Financial Supervision Commission (FSC) by delegation under the POSA.

Under the POSA, shares in a public company may be bought up to the threshold triggering a mandatory offer without initiating a bid procedure. Notification requirements only apply to smaller acquisitions. Generally, the FSC must be informed of the acquisition of voting rights in a public company directly or indirectly, provided that following the acquisition the voting rights of the acquirer reach or exceed 5 per cent or a multiple of 5 per cent of the total number of voting rights. There are some exceptions as well as complex rules for notifications about certain acquisitions with analogous effect.

The thresholds triggering mandatory takeover bids include acquisitions of more than one-third of the voting rights, as well as acquisition of more than half of the voting rights and more than two-thirds of the voting rights. Exceeding certain thresholds may also trigger the right to launch a voluntary takeover bid.

Takeover bids in respect of shares in public companies (which may be joint-stock companies only) are supervised by the FSC, provided that the public companies:

1. have a registered seat in Bulgaria and their shares are admitted to trading on a regulated market in Bulgaria or another country;
2. have shares admitted to trading on a regulated market in Bulgaria, provided that their shares are not admitted to trading on a regulated market in their home EEA Member State;
3. have shares admitted, for the first time, to trading on a regulated market in Bulgaria; or
4. have shares admitted simultaneously to trading on a regulated market in Bulgaria and in another EEA Member State, but the issuer has chosen the FSC as the competent authority to supervise the takeover bid.

Once a company has ceased to be 'public' in the meaning of the POSA and this is duly registered with the Bulgarian Commercial Register, M&A transactions in respect of such company will fall under the regime of the Bulgarian Commerce Act.

When the target is a public company, the price in a takeover bid is subject to the restrictions provided by the POSA. The price may not be lower than the highest of the following three:

1. the fair price of the shares, supported by detailed reasoning following the application of appraisal methods as set out in regulations enacted by the FSC;
2. the average weighted market price of the shares within the past six months; or
3. the highest price paid for the shares by the bidder during the past six months preceding the bid.

In addition, the POSA requires that certain information is provided to the buyers, such as information concerning the target shares that are already possessed directly or indirectly by the bidder, the term of the bid, the amount of compensation that will be paid to the other shareholders in the target if some of their rights are not observed and the plan for the future of the target company's business.

In a bid procedure under the POSA, the bid offer must be registered with the FSC and could be made public only if there is no prohibition imposed by the FSC within 20 business days of the registration. Furthermore, the management body of the target public company must produce a reasoned opinion on the proposed transaction, including the consequences for the company and its employees if the offer is accepted, the strategic plans of the bidder and their impact on the employees and the location where the company's business is carried out.

Apart from the rules applicable to the acquisition of public companies, transactions within certain regulated sectors (i.e., banking, insurance, pension assurance, media and telecommunications) may trigger compliance with various special rules in addition to the general rules governing the transaction under the Commerce Act. Typically, before the execution of the transaction, approval must be obtained from the relevant supervising body. For example, the acquisition or sale of a shareholding in a Bulgarian bank, whereby the thresholds of 20 per cent, 33 per cent or 50 per cent are reached or exceeded, triggers the requirement to obtain prior approval of the BNB.

Outlook and conclusions

As to what should be expected in the near future, Bulgaria is expected to adopt a number of laws for its Eurozone accession scheduled for 1 January 2025.

Furthermore, it is expected that important amendments will soon be made to the local financial collateral act (transposing the EU financial collateral Directive 2002/47/EC). The title of the law will change by adding 'close-out netting' alongside 'financial collateral', and a new chapter is expected to provide robust protection for close-out netting (either when used alongside or without financial collateral) as a crucial mechanism for financial transactions in Bulgaria. This is expected to boost, among other things, hedging instruments used regularly to hedge interest rate risks under large acquisition loans (i.e., above €50 million). In addition, certain shortcomings with the financial collateral arrangements including for both pledges and title transfer arrangements are expected to be remedied. A draft law amending the current financial collateral act was published for public consultation on 20 October 2023 and following the expiry of one month will be submitted for voting in the parliament.

Endnotes

1. Tsvetan Krumov is a partner, Kristina Lyubenova and Milena Gabrovska are attorneys at law and Katerina Tsoncheva is an associate at Schoenherr (in cooperation with law firm Stoyanov & Tsekova). ^ Back to section

2. On 4 April 2021, 11 July 2021, 14 November 2021, 2 October 2022 and 2 April 2023. ^ Back to section

3 By Decision No. 652 of 8 September 2022 supplementing Decision No. 265 of 2003 of the Council of Ministers of 2003, 12 natural persons have been included in the list (State Gazette, issue No. 73 of 13 September 2022). ^ Back to section

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Introduction

Leveraged lending is frequently used by Canadian borrowers to fund a number of activities, including acquisitions, capital expenditures, dividend recapitalisations, refinancing of existing debt and ongoing operations. Acquisition activity in Canada in 2023 has stabilised at the lower level of activity seen in 2022, due in part to rising interest rates, market uncertainty and the prospects of a recession, but leveraged loans continue to be an important source of capital for Canadian acquisitions. As the pace of rising interest rates has slowed, financing activity has started to increase, but it remains to be seen whether that trend continues into 2024.

i Recent Canadian acquisition activity

The first three quarters of 2022 saw a steady decline in mergers and acquisition activity. However, deal activity picked up again in the fourth quarter of the year, with 758 announced transactions having an aggregate deal value of C$90 billion, up from 684 announced transactions having an aggregate deal value of C$63 billion in the preceding quarter.[2] In 2022, a total of 3,040 transactions were announced, representing the lowest annual deal count since 2017.[3] Overall, these numbers reflect a softening Canadian mergers and acquisitions market. The metals and mining, industrials and information technology sectors were the most active in Q4 2022, ending the year with 117, 122 and 117 transactions, respectively.[4] The real estate sector experienced the largest decline in deal count in Q4 2022, ending with 60 transactions, a nearly 30 per cent decrease from Q3 2022.[5]

The market continued to stabilise in Q1 2023, with 721 announced transactions, only slightly below the average of 730 transaction announcements for the last three quarters of 2022.[6] Thirteen mega deals (transactions with an aggregate value in excess of C$1 billion) in Q1 2023 were announced with an aggregate value of C$41 billion, up from the eight announced transactions in Q4 2022 and down from the aggregate value of Q4 2022 mega deals, which was C$69 billion.[7] Q1 2023 saw an increase in deal activity in certain sectors, including precious metals, metals and mining, consumer staples and industrials.[8] The second quarter of 2023 continued to show signs of stability in mergers and acquisitions activity with 736 announced transactions worth C$74.4 billion, up 1 per cent and 44 per cent from Q1 2022, respectively.[9] However, the total of 1,457 transactions in the first half of 2023 represents a 9.6 per cent decline from the same period in 2022.[10] In Q2 2023, 14 mega deals were announced with an aggregate value of C$60 billion, the largest of which was the
C$23.9 billion sale of Viterra, a Canadian subsidiary of Swiss-based Glencore, to Bunge, a US-based agribusiness.[11] Ontario continued to be the most active province by deal count for the quarter with 188 deals, while Saskatchewan led all provinces by aggregate deal value with C$11.3 million, representing 43 per cent of all transactional value in Q2 2023.[12] Canadian mergers and acquisitions activity seems to be stabilising as the market shifts towards pre-pandemic activity levels and is coming to terms with the fact that higher interest rates will be with us for a while.

ii Canadian financing sources

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

For example, to secure their joint acquisition of Westinghouse Electric Company, Cameco Corporation and Brookfield Renewable Partners employed different funding methods, with the former securing a US$1 billion bridge loan facility and US$600 in term loans, and the latter financing through its normal course funding initiatives, including asset level upfinancings.[13] Corby Spirit and Wine Limited entered into a C$120 million financing with Pernod Ricard, its majority shareholder, in connection with the acquisition of 90 per cent of the outstanding shares of Ace Beverage Group Inc.[14] Saturn Oil & Gas Inc amended its existing credit facility to extend the maturity date and increase the size of the loan by C$375 million in relation to its acquisition of Ridgeback Resources Inc.[15] Lastly, in connection with its acquisition of Shaw Communications Inc, Rogers Communications Inc entered into a committed credit facility with a syndicate of banks in an original amount of up to C$19 billion that was eventually replaced with two senior notes issuances for combined proceeds amounting to C$13.3 billion and a C$6 billion term loan facility.[16]

Year in review

Market information for the first three quarters of 2023 indicates that Canadian mergers and acquisition activity is stabilising at the 2022 activity levels. Certain sectors of the Canadian economy, like metals and mining, industrials and information technology, continued to see strong activity, whereas others, like real estate, saw a substantial decrease. Irrespective of these market trends, 2023 continued to see purchasers involved in a Canadian transaction use debt as a major source of financing for their acquisitions. Such debt can be:

1. in the form of a short-term financing, as used by Cameco Corporation and Rogers Communications Inc in their respective acquisitions;
2. financed by a related party, like Corby Spirit and Wine Limited's financing with their majority shareholder; or
3. a modification of pre-existing debt, such as Saturn Oil & Gas Inc's upsizing of their pre-existing debt.

While there were no major changes to the law of secured financing in Canada in 2023, participants in the Canadian mergers and acquisition market should be mindful of the new priority rules for pension plans in a Companies' Creditors Arrangement Act (CCAA) restructuring or federal Bankruptcy and Insolvency Act (BIA) proposal that make pension plan diligence even more important, as well as the new French language rules in Quebec for contracts of adhesion. Parties involved in Canadian acquisition financings should also be mindful of proposed new tax legislation, such as the 'excessive interest and financing expenses limitation' (EIFEL) and anti-hybrid rules that, once in effect, may have immediate tax implications for those parties subject to these new rules.

Regulatory and tax matters

i Regulatory matters

Lender-related regulatory requirements

Canadian borrowers regularly obtain acquisition financing and leveraged finance products from a broad range of lenders, including domestic and foreign financial institutions, private equity and hedge funds, and through the issuance of public debt, including high-yield debt. Canadian and foreign banks are very active in this area and provide a wide variety of debt products to Canadian borrowers. The key regulatory issue for foreign 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 the operational requirements of the Bank Act on an ongoing basis.

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

In the absence of connection with a bank, foreign and other lenders that are not otherwise regulated as financial institutions in Canada (e.g., insurance companies, trust companies and credit unions) do not require any special licences or regulatory approvals to make a loan to a Canadian borrower. 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 they are not a financial institution exempted from compliance.

ii Withholding tax

Under the Income 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 or computed by reference to revenue, profit, cash flow, commodity price or similar criteria, or by reference to dividends paid or payable). Where interest is subject to withholding tax under the provisions of the Income 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, where applicable, 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.

iii Interest deductibility

Interest is only deductible to a Canadian-resident debtor where it meets certain technical requirements set out in the Income Tax Act. In particular, interest (not in excess of a reasonable amount) is generally deductible on:

1. borrowed money used for the purpose of earning income from a business or property; or
2. an amount payable for property that is acquired for the purpose of gaining or producing income from a business or property.

Interest payable on financing incurred to fund the acquisition of an asset to be used in the debtor's business should generally be deductible. Similarly, interest payable on financing incurred to fund the acquisition of shares of a company (where there is a reasonable expectation of income from the shares) should also generally be deductible. Where the Canadian-resident debtor incurs debt to finance the acquisition of shares, and it then amalgamates with or winds up the target company, the interest payable on that debt will generally continue to be deductible (on the basis that the income-producing shares are now replaced with income-producing assets).

iv Thin capitalisation rules

Under the Income Tax Act, interest payable by a Canadian-resident debtor may not be deductible to the debtor, and may be subject to Canadian withholding tax on an accrual basis, if the Canadian thin capitalisation rules apply. These rules generally apply where:

1. 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
2. the debt-to-equity ratio of the debtor in respect of such creditors exceeds 1.5:1.

The thin capitalisation rules may apply in a situation where acquisition financing is undertaken by a non-resident parent corporation, that then lends funds to its Canadian subsidiary, which acquires the target assets or shares.

Under Canada's 'back to back' rules, the thin capitalisation rules may apply where an intermediary is interposed between a non-resident creditor and a Canadian borrower, and the thin capitalisation rules would otherwise apply in respect of payments to the non-resident creditor.

v Recent amendments

In 2022, new interest deductibility and anti-hybrid structure rules were released, which may affect the deductibility of interest.

In November 2022, revised draft legislation was released respecting (among other measures) the previously proposed interest deductibility rules (i.e., EIFEL rules). Further revised draft legislation was released in August 2023. The EIFEL rules are broadly in line with OECD BEPS Action 4, and seek to introduce a limit on the amount of interest and financing expenses that resident and non-resident corporations and trusts can deduct in computing income. More specifically, the basic regime under the EIFEL rules generally limits the deduction of interest and financing expenses to 30 per cent of the taxpayer's 'adjusted taxable income' (i.e., tax EBITDA), with a transitional rate of 40 per cent for taxation years beginning on or after 1 October 2023 but before 1 January 2024. Interest and financing expenses that exceed the applicable limit in a particular year will not be deductible in that year, but generally may be carried forward and deducted in those future years (subject to the application of the EIFEL rules in those years). Certain Canadian corporations and trusts that do not exceed their applicable limit in a particular year generally will be permitted to transfer all or a portion of their 'excess capacity' to other Canadian corporations and trusts within their group. Furthermore, taxpayers generally may carry forward for up to three years their 'excess capacity' to be utilised in those future years (subject to the application of the EIFEL rules in those years).

Members of certain groups of corporations and trusts may be permitted to effectively opt out of the basic regime in a particular year and elect into an alternative (and potentially more favourable) regime under the EIFEL rules for that year. Where applicable, this alternative regime may permit members of the group to deduct interest and financing expenses beyond the 30 (or 40) per cent limit where the overall group has a higher 'group ratio' of net third-party interest expense to earnings.

As drafted, the EIFEL rules, once effective, will not apply to:

1. groups of corporations and trusts whose aggregate net interest expense among their Canadian members does not exceed C$1 million;
2. certain Canadian-resident corporations and trusts (and groups consisting of Canadian-resident corporations and trusts) that carry on substantially all of their business in Canada (provided that certain other requirements are met); or
3. Canadian-controlled private corporations that have (together with any associated corporations) taxable capital employed in Canada of less than C$50 million.

Individuals will also be exempt from the EIFEL rules.

Draft legislation respecting the anti-hybrid rules was also released in 2022, applicable to payments made on or after 1 July 2022. These rules are broadly in line with OECD BEPS Action 2. Under these rules, certain payments made by Canadian taxpayers under hybrid mismatch arrangements generally will not be deductible (and, in the case of interest payments, may be subject to Canadian withholding tax) to the extent that the payments are not included in the income of a non-resident recipient. Similarly, where a payment by

a non-resident is deductible for foreign income tax purposes, these rules generally will include an amount in a Canadian recipient's income (to the extent not otherwise included) or, in the case of a dividend payment that is deductible by the non-resident, restrict the Canadian recipient's ability to deduct the dividend received in computing its income (to the extent otherwise deductible). Draft legislation implementing other recommendations of OECD BEPS Action 2, including in respect of hybrid entity arrangements, is expected to be released in the future.

vi 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 interest on the acquisition financing against the target's operating income.

vii 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.

viii 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.

Security and guarantees

Secured loans are often used in Canada to finance acquisitions. The forms of security and guarantees most commonly used in the Canadian market to secure personal and real property assets, as well as the regime for taking security under the Civil Code of Québec (CCQ) and the common law applicable in the other provinces and territories, are discussed below.[17]

i Security

Personal property and tangible property

Common law provinces

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

Security in personal property is created under the PPSAs 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.

For secured financings in the Canadian market, tangible property normally means goods that are equipment or inventory. A security interest in goods must be perfected if a creditor is to have priority over the interests of other creditors and third parties. Registration of a financing statement in each province or territory where such tangible assets are physically located is necessary to perfect a security interest in those assets. The PPSAs are publicly accessible, searchable databases, and a registered financing statement serves as notice that a debtor's assets have been encumbered in favour of a secured creditor.

Chattel paper,[18] instruments, money, documents of title and large goods can also be perfected by a secured party by possession.

Quebec

Security over tangible movable property in Quebec is created by a hypothec. Registration at the Register of Personal and Movable Real Rights (RPMRR) perfects the hypothec. Applications for registration at the RPMRR must be drawn up exclusively in French. The foregoing implies that deeds of hypothec in English typically include collateral set out in French and English. 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. In 2022, the *Charter of the French Language* was subject to major amendments, some of which may impact domestic and foreign lenders, including banks and financial institutions. Since 1 June 2023, before a 'contract of adhesion' and related documents may be drawn up in English, a French version of the contract must have been remitted to the adhering party before execution. A contract in which the essential stipulations were imposed or drawn up by one of the parties, on its behalf or upon its instructions, and were not negotiable is a contract of adhesion. If it is possible for the debtor to freely negotiate with the creditor the essential clauses of the contract (regardless of whether such negotiations actually occur), the contract should not be deemed a contract of adhesion. In all cases, loan agreements as well as contracts used in 'relations with persons outside Quebec' are exempted from the new rule.

Federal jurisdiction

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

Personal property and intangible property

General – common law provinces

Intangible personal property commonly dealt with in the Canadian market includes claims and receivables, contractual rights and intellectual property (IP) rights.[19] Generally, creditors secure intangibles similarly to tangibles, by way of a security agreement and perfection by registration under the PPSAs.[20] The law of the jurisdiction where the debtor is located[21] at the time the security interest attaches governs the validity, perfection and priority of a security interest in intangible personal property. Accordingly, the secured party must file under the PPSA in the province or territory where the debtor is located to perfect against intangible personal property. Secured parties must also file in the jurisdiction the debtor is located to perfect non-possessory interests in certain collateral such as instruments, negotiable documents of title, money and chattel paper.

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

General – Quebec

Under the CCQ, the law of the jurisdiction where the grantor is domiciled (i.e., where its registered office is located) governs the validity and perfection of security over intangibles. Intangibles (incorporeal movable property) such as claims, receivables, contractual rights and IP rights owned by a debtor domiciled in Quebec are secured under the CCQ by way of a hypothec that is perfected by filing in the RPMRR. A hypothec on monetary claims is perfected by obtaining control over the claim (e.g., in the case of a deposit account, by the secured party entering into a control agreement with the financial institution holding the account).

Investment property

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

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

In addition to execution of a security agreement and filing under the PPSAs to perfect an interest in investment property, secured creditors can also establish 'control' or possession over such property. Control is the preferred 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 endorsement or having the securities registered in its name. For uncertificated securities, control is achieved by either registering the securities in the name of the secured party or by obtaining a control agreement from the issuer of the securities. A control agreement is a tripartite agreement among the issuer, the debtor and the secured party, and provides that the issuer agrees to comply with instructions from the secured party with respect to the securities without the debtor's further consent.

Where the investment property consists of securities entitlements held indirectly by the debtor through a securities intermediary, the secured party obtains control by:

1. arranging for the securities intermediary[22] to record the secured party as the entitlement holder;
2. obtaining a control agreement from the securities intermediary; or
3. having a third party obtain control on its behalf.

Real property

The most common forms of security over real estate in the Canadian market are mortgages, debentures, hypothecs and trust deeds. Real estate in the common law provinces and territories includes land (together with buildings and fixtures), airspace above land, crops, forests, non-navigable waters, easements, sub-surface land rights, rental income and other profits derived from land and leasehold interests. Real estate under the CCQ includes land, any constructions and works of a permanent nature located on the land and anything forming an integral part of the land, plants and minerals that are not separated or extracted from the land, personal property that is permanently physically attached and joined to an immovable and that ensures its utility and real rights in immovable property, as well as actions to assert these rights or to obtain possession of immovables.

Each province and territory in Canada has a real property title registration system. Secured creditors perfect interests in real property by filing their mortgage, debenture, hypothec or trust deed against the title to the debtor's real property. The filing of hypothecs at the Quebec Land Registry Office must be made exclusively in French. 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 some special statutes in Canada that govern most federally regulated facilities such as airports, prisons and major shipping ports, and these should be assessed when taking security involving these types of facilities.

ii Guarantees

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

iii Guarantee limitations

Financial assistance

Corporate legislation in Canada has eliminated outright restrictions on financial assistance. It is permitted without restrictions of any kind in several provinces, including Ontario and Nova Scotia. In other provinces and territories, financial assistance is also permitted generally but is subject to a solvency test or disclosure requirements. The more relaxed regime has provided increased flexibility to lenders in Canada when structuring security packages that include guarantees.[23]

Corporate benefit

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

iv Agency concept

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

v Challenging security under Canadian law

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

In the context of insolvency proceedings, a trustee in bankruptcy[24] can challenge preferences and other transactions at undervalue under the 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 time 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 time 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, alternatively, 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 are 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 CCAA.[25]

Provincial legislation is also available to creditors or trustees to attack preferential transactions. While there are differences among the various provincial statutes, most provinces allow a creditor to attack fraudulent conveyances and unjust preferences.[26-] In general terms, fraudulent conveyances are transactions where conveyances of real or personal property are made with the intent to defeat, hinder, delay or defraud creditors or others. Unjust preferences are preferential payments or transactions made when the debtor was in insolvent circumstances, unable to pay its debts or knew it was on the brink of insolvency. Transactions found to be fraudulent conveyances or unjust preferences can be voided as against creditors.

Finally, in almost all Canadian provinces and territories, creditors may use the oppression remedy under corporate law to challenge security given by a corporation. This would involve a transaction where the corporation or its directors effected a result or acted in a manner that was oppressive, unfairly prejudicial to or unfairly disregarded the interests of certain parties (including creditors). Where oppressive conduct is found, Canadian courts have broad discretion to grant any remedy they deem appropriate in the circumstances.

Priority of claims

i Priority claims

In Canada, 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 the BIA, or petition itself into bankruptcy under the BIA.

In a Canadian insolvency proceeding, certain claims may be afforded priority over a secured lender pursuant to a court order and the priority of these claims will be determined by the court based on the facts of each case. The court may, for example, 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, directors' corporate indemnities, key employee retention payments and professional administration fees.

In addition, certain statutory claims will continue to have priority over a secured lender's claim in an insolvency proceeding. In a bankruptcy scenario, these include:

1. claims for unremitted employee source deductions;
2. certain employee claims that are paid by the Canadian federal government under the Wage Earner Protection Program Act in a bankruptcy or receivership scenario; and
3. certain employee and employer pension plan contributions that are due and unpaid.

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 liquidating restructuring proceedings under the CCAA or the BIA where the company is expected to become subject to a bankruptcy or receivership, a court may order employee claims under the Wage Earner Protection Program Act to be paid before the company's bankruptcy or receivership proceedings are commenced, and provided the court is satisfied that all employees have been dismissed. Notably, a number of the Canadian federal and provincial statutory deemed trusts that can prime a lender's security outside a bankruptcy or CCAA proceeding for unpaid amounts, such as sales taxes, will be reversed in a bankruptcy or CCAA proceeding of the insolvent borrower.[27] However, where a statutory trust satisfies the general principles of trust law for creating a true trust, the assets impressed with the trust would be excluded from any distribution to the insolvent borrower's secured creditors in the bankruptcy proceedings.[28]

As noted above, certain pension claims may rank in priority to a lender's security in the event of a borrower's insolvency, including claims in respect of:

1. unpaid normal cost contributions;
2. special payments required to be paid to liquidate an unfunded liability or solvency deficiency; and
3. any amount required to liquidate any other unfunded liability or solvency deficiency of the pension fund.[29]

The priorities in respect of items (b) and (c) were recently enacted. They apply immediately for pension plans created on or after 27 April 2023. For pension plans established before 27 April 2023, there is a four-year integration period before the priority will take effect on 27 April 2027.

Notably, the Supreme Court of Canada decision in *Indalex Limited (Re)*[30] 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.[31] 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)*,[32] which considered Alberta's provincial regulatory regime regarding abandonment and reclamation obligations (or end-of-life obligations) with respect to abandoned oil wells.[33] 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 majority of the Supreme Court held that, for a number of reasons, the regulator's use of its provincial statutory powers to enforce compliance with end-of-life obligations under Alberta's provincial legislation does not create a conflict with the BIA and therefore does not trigger the doctrine of federal paramountcy.[34] 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.[35]

The treatment of environmental obligations in insolvency is an evolving issue,[36] and the applicable provincial regulatory regime will factor significantly into a court's determination.-[37] Lenders will want to ensure they understand the applicable provincial regulatory regime and its application in a potential insolvency, and ensure that lending values account for such risks where a Canadian borrower has potential environmental liabilities.

ii Equitable subordination

Under the US Bankruptcy Code, the doctrine of equitable subordination allows courts to subordinate creditor claims to those of lower-ranking creditors. This extraordinary remedy is typically reserved for situations of egregious conduct on the part of creditors, because it supplants negotiated contractual arrangements between parties. For a claimant to succeed in subordinating a creditor claim, it must demonstrate that the creditor engaged in inequitable conduct, that the conduct harmed other creditors of the bankrupt company or 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, 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*,[38] whereby, rather than ruling one way on the doctrine's applicability, it declared that the facts at hand did not give rise to a claim for equitable subordination and left its determination for a later date.[39] In its subsequent decision in *US Steel Canada Inc (Re)*,[40] 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.

iii Second lien financings

As noted above, a Canadian borrower may incorporate several types of indebtedness (including second lien loans) in its capital structure. Second lien 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. Often these loans are provided in US dollars and 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 are 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.

iv Intercreditor agreements

Lenders have made a broad variety of debt products available to borrowers to finance their operations, acquisitions and other activities. As a result, many borrowers have complex capital structures with several layers of debt secured by liens on the same collateral. For example, a borrower may have a senior term and operating credit facility, hedging obligations, cash management obligations and a second lien term loan or notes secured by liens on the borrower's assets. Lenders in these circumstances typically enter into an intercreditor agreement that delineates their respective rights, remedies and priorities, particularly in a default situation. Canadian courts generally treat an intercreditor agreement as an enforceable contract between the lenders and uphold its provisions. However, if the borrower in question is subject to an insolvency proceeding, it is possible that the court supervising the proceeding may make an order that is not consistent with

the provisions of the applicable intercreditor agreement in exercising its jurisdiction over the matter.

The terms of any particular intercreditor agreement are influenced by the borrower's creditworthiness and capital structure, the type and terms of the relevant debt, the lenders' 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:

1. the relative priority of liens on the collateral;
2. the application and turnover of proceeds derived from the collateral, payment restrictions or blockage periods with respect to junior debt payments;
3. restrictions on the type and amount of senior debt that ranks prior to more junior debt;
4. standstill periods and other restrictions on enforcement proceedings by holders of junior debt;
5. access rights to certain collateral;
6. restrictions on certain modifications to the terms of each lender's credit documentation;
7. refinancing rights; and
8. the right of junior debt holders to purchase the senior debt.

Triggers for junior debt payment blockages, the frequency and length of payment blockage periods as well as the right to make catch-up payments once a payment blockage has ceased are often heavily negotiated. The elements and amount of senior debt (including interest rate and fee increases, over-advances, prepayment premiums and hedging obligations) that ranks in priority to the junior secured debt are also frequently the subject of much discussion.

Jurisdiction

It is not uncommon for acquisitions in Canada to be financed by foreign lenders based in financial centres such as New York or London. This occurs most often when the buyer is a foreign entity or the Canadian target is part of a larger cross-border or international corporate structure, but also more recently in largely Canadian-based transactions. 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, as long as the choice of the foreign law in the agreement is bona fide, legal and not contrary to public policy. Canadian courts will apply local law to procedural matters and apply local laws that have overriding effect. In addition, Canadian courts will not apply foreign law if to do so would have the effect of enforcing a foreign revenue, expropriation or penal law.

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

ii Enforcement of foreign judgments

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

Certain defences are available to debtors in Canada to prevent recognition and enforcement of a foreign judgment against them. The foreign judgment cannot have been obtained by fraud or in a manner contrary to natural justice. In addition, the foreign judgment cannot be for a claim that under Canadian law would be characterised as being based on a revenue, expropriatory or penal law; nor can the foreign judgment be contrary to public policy. Finally, Canadian 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 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.[41]

Acquisitions of public companies

In Canada, acquisitions of public companies are generally implemented through:

1. takeover bids pursuant to which the acquirer bids for the shares of the target (and which may or may not be followed by a compulsory acquisition of those shares that are not tendered into the bid or a second stage going private transaction);
2. a plan of arrangement (whereby a company can pursue a broad range of fundamental changes under a single transaction that is court approved); or

3. an amalgamation of the target company with the acquirer.

In Canada, acquisitions of public companies are generally effected by way of a takeover bid or plan of arrangement.

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

There are several issues that are unique to the financing of acquisitions of public companies in Canada. While many of these issues vary based on the specific provincial corporate and securities laws that are applicable in any given transaction, the general approach and issues raised are common in all Canadian jurisdictions.[42]

i Conditionality and availability of funds

Canadian securities laws establish an 'availability of funds' requirement for takeover bids of Canadian public companies. In this regard, Section 2.27 of National Instrument 62-104 (Take-Over Bids and Issuer Bids) states that where a bid provides that the consideration for the securities deposited under such bid is to be paid, in whole or in part, in cash, 'the offeror must make adequate arrangements before the bid to ensure that the required funds are available to make full payment for the securities that the offeror has offered to acquire'.[43] In addition, the financing arrangements can be subject to conditions only if, at the time the bid is commenced, 'the offeror reasonably believes the possibility to be remote that, if the conditions of the bid are satisfied or waived, the offeror will be unable to pay for the securities deposited under the bid due to a financing condition not being satisfied'.[44]

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

ii Two-stage transaction

Generally, acquisition financings are secured by, among other things, the collateral of the target company. In fact, the credit rating and the value of the assets owned by the target company are significant components in the lenders' analysis of the amount of credit they are willing to provide to finance an acquisition. In connection with an acquisition where the offeror aims to acquire all of the outstanding shares of the target company, the minimum tender condition is generally set at approximately 66.67 per cent. This allows the offeror to achieve a certain level of security regarding the outcome of the bid.

If an offeror acquires more than 90 per cent of the securities subject to the bid (excluding those previously held by it), both Canadian federal and provincial legislation provides for a procedure for the compulsory acquisition of the balance of the shares within a certain period. In the event less than 90 per cent but more than approximately 66.67 per cent of the outstanding securities are acquired, the offeror can complete the acquisition of 100 per cent of the securities of the target company by means of a subsequent going-private transaction. In this circumstance, the offeror can vote the shares that were tendered to it under the bid. Because the voting threshold under applicable law for approval of a going-private transaction is approximately 66.67 per cent (75 per cent for some jurisdictions) of the shares voting at the shareholders' meeting called to approve the transaction, the offeror can be assured that the transaction will be approved.

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

iii Disclosure requirements

There are disclosure requirements under Canadian securities laws with respect to the terms of a financing related to the acquisition of a public company. In the context of a takeover bid where a financing is involved, the takeover bid circular must state the name of the lenders, the terms and conditions precedent to the financing, the circumstances under which the loan must be repaid and the proposed method of repayment.[45] These disclosure requirements are easily satisfied by including a summary of the terms and conditions of the financing in the circular, which must be in the form prescribed.[46]

Outlook and conclusions

Secured debt continues to be a popular source of funds for Canadian borrowers although lending activity is somewhat volatile and subject to market conditions. As noted above, the volume of leveraged loans to fund M&A transactions is declining, given the rapid increase in interest rates since March 2022 and ongoing economic uncertainty. However, demand for project and infrastructure financings, including for various Canadian mining and natural resources projects, remains strong and we expect demand for secured leveraged loans to increase once again as a source of funding for acquisition financing, the refinancing of maturing indebtedness and as part of corporate restructurings given the volatility in public markets for debt and equity, and the expectation that interest rates will start to reduce again in the first half of 2024.

Endnotes

1 David Nadler, David Wiseman, Dan Dedic, Caroline Descours and Michael Royal are partners and
Cathy Costa-Faria and Zhiyao Chen are associates at Goodmans LLP. Keyvan Nassiry is the founding partner of Nassiry Law Inc. ^ Back to section

2 Crosbie & Company, M&A Quarterly Canadian M&A, online: www.crosbieco.com/who-we-are/mapublications. The figures provided are a compilation from 2022 quarterly reports. ^ Back to section

3 ibid. ^ Back to section

4 ibid. ^ Back to section

5 ibid. ^ Back to section

6 Crosbie & Company, M&A Quarterly Canadian M&A Online: www.crosbieco.com/who-we-are/mapublications. The figures provided are a compilation from 2023 quarterly reports. ^ Back to section

7 ibid. ^ Back to section

8 ibid. ^ Back to section

9 ibid. ^ Back to section

10 ibid. ^ Back to section

11 ibid. ^ Back to section

12 ibid. ^ Back to section

13 *2022 Annual Report* (Saskatoon: Cameco Corporation, 2022), online (pdf): cameco.com> [perma.cc/8KGR-RS7G]; Brookfield, Press Release, 'Cameco and Brookfield Renewable Form Strategic Partnership to Acquire Westinghouse Electric Company' (11 October 2022), online: bep.brookfield.com> [perma.cc/497Z-SM5M]. ^ Back to section

14 'Corby Spirit and Wine Limited to Acquire Ace Beverage Group',*Cision* (12 June 2023), online: newswire.ca> [perma.cc/FWG2-36AJ]. ^ Back to section

15 Saturn Oil + Gas Inc, News Release, 'Saturn Oil & Gas Inc. Announces Acquisition of Ridgeback Resources Inc. Expanding Production to Approximately 30,000 boe/d and Bought Deal Financing including Strategic Lead Orders from GMT Capital Corp. and Libra Advisors, LLC' (20 January 2023), online: saturnoil.com> [perma.cc/25Y5-WQDM]. ^ Back to section

16 *Interim Condensed Consolidated Financial Statements (unaudited)* (Toronto: Rogers Communications Inc, 2022), online (pdf): investors.rogers.com> [perma.cc/EB89-PQAM]. ^ Back to section

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

18 In Ontario, as of 15 May 2020, the PPSA was modernised to recognise both tangible, 'wet ink' chattel paper and electronic chattel paper. Similar amendments were made to the PPSA in Saskatchewan in 2019. In Ontario, under the new regime, electronic chattel paper can be perfected by control. Related changes have been made to the conflict of laws and the priority rules. Given the recognition of electronic chattel paper in the United States under the Uniform Commercial Code and the Ontario and Saskatchewan PPSAs, we expect that in time the PPSAs in the other Canadian provinces and territories will be updated with similar changes. ^ Back to section

19 The PPSAs expressly exclude an interest in or claim under any insurance policy or annuity contract from their scope. Secured debtors must take steps outside of the PPSAs to secure an interest in an insurance policy. The PPSAs do, however, provide that a previous security interest in other secured personal property assets extends to the proceeds of insurance on the assets. In Quebec, insurance policies can be charged by a hypothec (with a special perfection regime for hypothecs over life insurance policies). ^ Back to section

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

21 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. However, in Ontario, British Columbia and Saskatchewan, deeming rules for determining a debtor's location more easily and with more certainty have recently been enacted. We expect the balance of provinces and territories to implement similar rules over the next several years. The updated rules determine a debtor's location based on what type of entity the debtor is. For example, in Ontario provincial corporations are deemed to be located in the province or territory of incorporation or organisation. ^ Back to section

22 For example, a clearing house, retail investment broker or bank. ^ Back to section

23 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. As expected, these 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 parent 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. ^ Back to section

24 Where a trustee refuses or neglects to take proceedings after being requested to do so by a creditor, that creditor may make an application to the court for an order authorising it to take the proceedings in question in its own name and at its own expense and risk, on notice being given the other creditors of the contemplated proceeding, and on such other terms and conditions as the court may direct. ^ Back to section

25 In which case, a CCAA court-appointed monitor could challenge preferences and other transactions at undervalue. See Section 36.1(1) of the CCAA. ^ Back to section

26 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 the CCAA and outside the proceedings. ^ Back to section

27 In*Callidus Capital Corp v. Canada*, 2018 SCC 47, the Supreme Court of Canada denied a taxing authority's efforts in the bankruptcy proceedings of the debtor 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. ^ Back to section

28 In*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. In *Urbancorp Cumberland 2 GP Inc (Re)*, 2020 ONCA 197, in the context of a CCAA proceeding, the Ontario Court of Appeal found that Ontario's Construction Lien Act (now the Construction Act) creates a valid trust pursuant to general trust law, and this statutory provincial trust can be effective in an insolvency to the extent it does not conflict with a specific priority under federal law. ^ Back to section

29 'Unfunded liability' is the additional amount required to ensure plan assets meet the plan liabilities. 'Solvency deficiency' is the additional amount required to ensure the fund meets its obligations if it were to be wound up. ^ Back to section

30 2013 SCC 6 (*Indalex*). ^ Back to section

31 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). ^ Back to section

32 2019 SCC 5. ^ Back to section

33 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. ^ Back to section

34 The doctrine of federal paramountcy establishes that where there is a conflict between valid provincial and federal laws, the federal laws will prevail and the provincial laws will be inoperative to the extent they conflict with the federal laws. ^ Back to section

35 See also*Manitok Energy Inc (Re)*, 2022 ABCA 117. ^ Back to section

36 Notably, Qualex-Landmark*Towers Inc v.* 12-10*Capital Corp*, 2023 ABKB 109 is the first decision to apply *Redwater* to non-insolvency proceedings between two private parties. This case is subject to appeal. The appeal is expected to consider whether a private party can have a super-priority right in respect of environmental obligations that could subordinate the rights of pre-existing secured lenders. ^ Back to section

37 See, for example,*British Columbia (Attorney General) v. Quinsam Coal Corporation*, 2020 BCSC 640, where the British Columbia Supreme Court distinguished *Redwater* on the basis that the Alberta regime regulating the abandonment, closure and reclamation of oil and gas wells is different from British Columbia's Mines Act and allowed certain sale proceeds to be paid to the secured creditor while there remained unfulfilled regulatory obligations, including reclamation obligations imposed under the Mines Act. See *Eye Hill (Rural Municipality) v. Saskatchewan (Minister of Energy)*, 2023 SKKB 52, where the Saskatchewan Court of King's Bench applied *Redwater* on the basis that Saskatchewan's regulatory regime is based on Alberta's regime. The court held that the Minister of Energy and Natural Resources' claims for end-of-life environmental obligations had priority over the claims of various municipalities for unpaid municipal taxes. ^ Back to section

38 [1992] 3 SCR 558, paragraph 44. ^ Back to section

39 *Indalex*, note 29 at paragraph 77. ^ Back to section

40 2016 ONCA 662 (*US* Steel). ^ Back to section

41 *ZI Pompey Industries v.* Ecu-Line*NV* [2003] 1 SCR 450. ^ Back to section

42 We have focused on the laws of the province of Ontario in our analysis of these issues below. ^ Back to section

43 National Instrument 62-104 – (Take-Over Bids and Issuer Bids) (2016), 39 OSCB (Supp-1) 63, Section 2.27(1). ^ Back to section

44 ibid., Section 2.27(2). ^ Back to section

45 National Instrument 62-104 – (Take-Over Bids and Issuer Bids), Form 62-104F1 – Take-Over Bid Circular at item 12. ^ Back to section

46 See prescribed form in National Instrument 62-104 – (Take-Over Bids and Issuer Bids), Form 62-104F2 – Issuer Bid Circular. ^ Back to section

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Introduction

Commercial banks are the primary source of debt finance in acquisition transactions. Trust companies and finance companies also play an important role in the debt financing market. Unsecured credit facility, secured facility, revolving facility for working capital purposes, bonds and convertible bonds are the most commonly used debt products. Mezzanine finance is commonly seen in China in innovative transaction. Hybrid debt-plus-securities instruments are also commonly arranged, under which companies can issue securities backed by the credit assets consisting of the debts arising out of a number of loans of multiple borrowers in the national inter-bank bond market or stock exchanges, and the qualified investors may be able to negotiate and trade these securities.

Private equity (PE) and venture capital (VC) are other important sources of funding and are becoming more and more important in the acquisition market. However, PEs or VCs mainly provide equity finance, since debt finance by PEs or VCs is limited in China.

Year in review

M&A transactions in China decreased in the past year in both numbers and transaction value. Transaction value decreased by 20 per cent compared to last year, the lowest level since 2014. PEs or VCs are still active in investment and play an important role in the M&A market and, therefore, the number of M&A deals stays stable with a slight drop.

Large deals, in which the single transaction value exceeded US$1 billion, dropped significantly in the past 12 months. Among these, more than half are done by state-owned enterprises. Most large deals were consistent with key domestic economic themes, such as industrial upgrading, dual circulation and low-carbon environmental protection.

Cross-border M&A continued to be sluggish owing to strict travel restrictions and geopolitical risks.

Regulatory and tax matters

In China, an entity can only conduct lending business after obtaining permit or approval from finance regulators, such as People's Bank of China (PBOC), National Administration of Financial Regulation (NAFR, formerly known as China Banking and Insurance Regulatory Commission or CBIRC) or the finance regulation bureau of a local government. Major market players in the debt financing industry are commercial banks, policy-orientated banks, trust companies, finance companies, lending companies and micro-lending companies, which should conduct business according to the applicable laws and regulations.

i Acquisition finance

Commercial banks, policy-orientated banks, Chinese branches of foreign banks and finance companies of enterprise groups should comply with the Guidelines for Risk Management of Acquisition Financing by Commercial Banks (the Acquisition Finance

Guidelines) promulgated by the CBIRC in 2008 and amended in 2015. The Acquisition Finance Guidelines stipulate that the financing amount may not exceed 60 per cent of the total acquisition price of a transaction and the term of the loan may not exceed seven years.

According to the Acquisition Finance Guidelines, a lender conducting acquisition financing business must:

1. have sound risk management and an efficient internal control mechanism;
2. have a capital adequacy ratio of no less than 10 per cent;
3. meet applicable regulatory requirements in all of its other regulatory indices; and
4. have a professional team to conduct the due diligence and risk assessment of acquisition financing.

The Acquisition Finance Guidelines also set forth the requirements for the acquisition financier to maintain an internal control and risk management system, including:

1. ensuring its aggregate outstanding amount of acquisition financing does not exceed 50 per cent of its net tier 1 capital for the same period, and its aggregate outstanding amount of acquisition financing to a single borrower does not exceed 5 per cent of the net tier 1 capital for the same period;
2. assessing the strategic, legal, regulatory, concentration, business, financial and regulatory risks of an acquisition transaction;
3. reporting to the NAFR the concentration limit on a per-borrower, group customer, industrial, national or jurisdictional basis;
4. ascertaining the leveraged ratio of acquisition financing and ensuring reasonable funding by equity contribution;
5. strengthening due diligence and post-lending loan management and supervision; and
6. adding mandatory provisions in the facility agreement to protect the lender's right, such as the provisions on the lender's right to take risk control measures upon occurrence of material adverse change in the target group and the equity funding as a condition precedent to the disbursement of the acquisition financing.

ii Syndicated loan

The Guidelines for Syndicated Loan Business (the Syndication Guidelines), promulgated by the NAFR, stipulates the rights and responsibilities of the lead bank, agent bank and participating bank, form of syndication and documentation requirement. If a single bank acts as the lead bank, its commitments should not be less than 20 per cent of the total commitment, and the participating shares of the other members should not be less than 50 per cent of the total commitment.

iii Anti-money laundering and anti-corruption compliance

As a member of the Financial Action Task Force, China is devoted to fighting money laundering and terrorism financing. The PBOC is the key regulator of anti-money laundering and counterterrorism financing. In addition to the Anti-Money Laundering Law, there are several regulations issued by the PBOC that stipulate detailed requirements for financial institutions to comply with, including identifying a client's identity, preserving information about their clients and transactions and reporting large transactions or suspicious transactions.

The Criminal Law establishes a criminal offence in relation to money laundering. The Supreme People's Court and the Supreme People's Procuratorate may issue guidelines on the application of criminal law to combat money laundering activities.

Anti-corruption is largely stipulated in the Criminal Law, Anti-Unfair Competition Law and related regulations. There is no legislative guidance specifically applicable to financial institutions regarding the administration of anti-corruption matters.

iv Tax

Interest on loans is taxable income and, unless otherwise stipulated by law, the taxable income of the enterprises is generally subject to 25 per cent of the corporate income tax in China. The overseas branch office (with no legal person status) of a Chinese resident bank is considered a resident of China for tax purposes. The income of the overseas branch office is taxable together with its head office, and no withholding tax is payable for the interest paid from a domestic institution to the overseas branch office provided that, if the overseas branch collects the interest on behalf of a non-Chinese resident, the domestic enterprise is obligated to withhold income tax for the interest paid to the overseas branch. If the actual management organ of a Chinese enterprise's overseas subsidiary is located in China, the overseas subsidiary will be considered a Chinese resident as well.

Interest expenses are deductible against operating income of the borrower.

Unless otherwise stipulated in the tax treaties or other tax preferential treatment, a Chinese resident borrower should withhold corporate income tax at the rate of 10 per cent for the interest paid to the non-resident lender.

Financial institutions are subject to 6 per cent VAT for income accrued from the debt financing. A VAT exemption is granted if the loan is made to small or micro enterprises or self-employed households.

Parties to a loan agreement executed within the territory of China 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.

Security and guarantees

The types of security under Chinese law include mortgages, pledges, guarantees and liens. The security package most commonly used in acquisition finance transactions are share pledges, cash deposits, corporate or personal guarantees or a combination of the above. A mortgage of real estate (including land use right), pledge over receivables or intellectual property rights may also be required by a lender providing leveraged finance.

A grant of cross-border security or guarantee is subject to regulation of the State Administration of Foreign Exchange (SAFE); for example, the provision of a guarantee or security by an onshore non-bank entity in favour of an overseas entity securing the debt of an overseas borrower should be registered with the SAFE after the execution of security documents.

In the case of a listed company takeover, the listed company should not provide any form of financial assistance to the acquirer, or any security in favour of the acquirer or its affiliate.

Security is revocable if it is granted within one year of the court accepting a bankruptcy application with respect to the security provider to secure an unsecured debt.

Priority of claims

Secured claims should be repaid in priority from the proceeds of the secured assets. After full repayment of the secured claims, the remaining amount of the proceeds of the secured assets (if any) will be considered as the bankruptcy assets of an insolvent borrower.

Other claims should be paid in the following order from the bankruptcy assets:

1. administrative fees and expenses in connection with the bankruptcy proceeding and debts incurred for the common good of creditors after the initiation of bankruptcy proceeding;
2. wages, subsidies for medical treatment, injuries and disability, and pensions for the disabled and the families of the deceased the debtor owes, the basic health and pension benefits that should have been paid to the employees' personal accounts and other compensation that should have been paid to the employees as prescribed by law;
3. other social insurance premiums and tax that the bankrupt has failed to pay; and
4. unsecured claims.

In China, subordinated bonds can only be issued by a financial institution in accordance with applicable law and regulations. In addition, contractual subordination arrangements are not recognised by the Bankruptcy Law; therefore, it is uncommon to see this in practice.

Jurisdiction

i Governing law

In a domestic transaction, Chinese law should be the governing law of the transaction agreement. In cross-border transactions, the parties may choose the governing law of the transaction agreements. English law, Hong Kong law and New York law are most often chosen by the parties as the governing law of the cross-border credit facility agreement.

In the absence of a choice of law, the court will apply the rules of closest connection to determine the governing law. For example, the law of the jurisdiction in which the lender is located may govern the financing agreement.

There are some exceptions to the parties' freedom of choice of law. Where the collateral is the immovable asset, the law of the jurisdiction where the immovable assets are located should be the governing law of the security agreement. Chinese law mandatorily applies to certain agreements relating to foreign investment in China, such as, for example, share purchase agreements, asset purchase agreements and subscription agreements involving foreign entities, as well as Sino-foreign equity joint venture contracts, Sino-foreign contractual joint venture contracts and contracts for Sino-foreign joint exploration and development of natural resources that will be performed within China.

Generally, the courts will uphold the choice of law provisions as long as such provisions do not violate the public policy of China or contradict the mandatory provisions of Chinese law.

If the court determines that the parties intentionally create the ground to apply foreign law to avoid the application of Chinese law, it will not uphold the application of foreign law and Chinese law will apply instead.

ii Recognition of foreign judgment or arbitration award

China is a contracting state of the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958. A foreign party may submit an arbitral award from a foreign arbitral tribunal to a Chinese court for recognition and enforcement. If the court determines that recognition and enforcement does not violate the basic principles of Chinese law and is not contrary to the sovereignty, national security or public policy of China, it will recognise the arbitration award.

Where the final and conclusive civil judgment or written order of a foreign court is submitted to a Chinese court for recognition and enforcement, it will be reviewed by the court in accordance with the international or bilateral treaty concluded by or between China and the jurisdiction where the judgment order is made or in accordance with the principle of reciprocity. If there is an international or mutual enforcement treaty, then court judgment will be enforced according to the treaty. Without an enforcement treaty, enforcement could be made under the reciprocity principle. There is no definition of reciprocity principle under Chinese law. The current Chinese court practice is that if there is a precedent that a foreign jurisdiction enforced a Chinese court judgment, then the Chinese court may enforce the court judgment of that jurisdiction under the reciprocity principle. In the suggestion to promote the Belt and Road Initiative (BRI), the Supreme People's Court proposed that a Chinese court may consider first enforcing a foreign judgment so as to actively establish a reciprocal relationship if that foreign jurisdiction has committed to giving China reciprocal treatment or if there is good judicial cooperation between China and that jurisdiction. The newly revised Civil Procedure Law, which will be effective from 1 January 2024, lists situations where a foreign court judgment will be rejected. These situations include where:

1. the foreign court has no jurisdiction;
2. the respondent has not been duly notified nor represented;
3. the judgment was obtained through fraud;

4. there is an effective Chinese judgment for the same subject; and
5. the judgment is contrary to the sovereignty, national security or public policy of China.

Acquisitions of public companies

The Administrative Measures for Takeover of Listed Companies (the Takeover Measures) promulgated by the China Securities Regulatory Commission (CSRC) are the principal regulations on the acquisition of public companies. The acquisition of listed companies can be made through an agreement or tender offer.

i Mandatory offer requirement

If the investor, acting alone or jointly with others by agreement, wishes to purchase the shares of a listed company from a third party by agreement, so that the aggregate shares held by the purchaser would exceed 30 per cent, the purchaser should launch the general tender offer to acquire all the remaining shares of the target company before completion of the purchase by agreement.

If the investor holding more than 30 per cent of the shares of a listed company wishes to further increase its shareholding percentage acting alone or jointly with others by agreement, it should launch the tender offer to acquire all or part of the shares of the target company.

The tender offer requirement may be exempted in certain cases set out in the Takeover Measures.

ii Disclosure of the financing terms

The tender offer report should, among other things, disclose the term and price of the acquisition, the source of funding required for the acquisition and the guarantee structure in relation thereto. The purchaser must engage a financial adviser who will conduct adequate due diligence on the purchaser's capacity to pay the takeover price and the source of funds, disclose the verification process and basis in detail, and state whether the purchaser has the capacity to make the tender offer.

iii Squeeze-out

There are no squeeze-out rules in China. However, in the case of a general tender offer, the purchaser is required to specify in the offer report, among other things, the closing date after delisting and arrangements for the shares held by the remaining shareholders after expiry of the offer period. If, at the end of the offer period, the target company fails to meet the listing requirement (i.e., less than 25 per cent of the shares are held by the public, or in the case of the total value of the shares of the target exceeding 400 million yuan, less than 10 per cent of shares are held by the public), the target company should be delisted. If requested by the remaining shareholders, the purchaser should purchase the shares

held by the remaining shareholders within the timeline as provided in the purchaser's offer report on the same terms as the tender offer.

iv Conditionality

In the case of a tender offer, the purchaser should first prepare the offer report and disclose the summary of the offer report in a brief announcement. All the conditions to the offer must be highlighted in the summary of the report. The offer report will be disclosed after the conditions have been satisfied. Unless otherwise waived by the CSRC, the offer report is unconditional.

Chinese law currently does not stipulate requirements on the offer conditions. Obtaining governmental approval is commonly seen as a condition in the summary of the offer. There are cases where a satisfactory due diligence result is the condition in the summary of the offer.

v Form of payment

The purchaser may, by means of cash, securities or a combination of the two, or by other lawful consideration, pay the purchase price for acquisition of a listed company. In the case of payment in securities, the purchaser should:

1. provide audited financial and accounting statements;
2. provide a securities evaluation report of the securities issuer for the past three years;
3. and cooperate with the independent financial adviser engaged by the target company in its due diligence investigations.

In the case of payment in transferable bonds, the bonds must have been listed on the securities exchange for at least one month. In the case of payment in securities that are not listed on any securities exchange, the purchaser must provide a cash payment option for the offerees to choose from.

In the case of a general tender offer to acquire all the shares of the target company, the consideration should be paid in cash. If the purchaser wishes to pay the consideration by transferable securities, it must, at the same time, offer the cash payment option for the offerees to choose.

vi Certain funds requirement

The purchaser should provide at least one of the following measures to guarantee performance:

1. in the case of payment of the purchase price in cash, a deposit of no less than 20 per cent of the total consideration to the bank account designated by the securities depository and clearing institution;
2. in the case of payment of the purchase price in securities, the securities used for payment must be deposited in the custody of the securities depository and clearing institutions;

3. a bank guarantee covering the total purchase price; or
4. a written commitment issued by the financial adviser undertaking joint and several liability for payment of the purchase price.

The financial adviser of the purchaser is also required to specify whether the purchaser may complete the tender offer in its report and whether there is any circumstance in which the purchaser may obtain the financing by mortgaging the target shares.

Outlook and conclusions

With the reopening of China after the covid-19 epidemic, M&A transactions of Chinese enterprises may increase in the coming year. But the investors tend to be cautious, although there are many favourable factors that would promote M&A transactions in 2023, such as removal of covid restrictions, relaxing of restrictions on the internet economy and absorption of risks on real estate.

Geopolitical risks may continue to have negative effects on M&A transactions, which may take some time to ease. The uncertainty caused by geopolitical risks has the greatest impact on large-scale globalised dollar-based funds, and it is still unknown whether these are willing to return to the M&A market at present; this depends to a great extent on the development of Sino-US relations, which is hard to predict.

Therefore, Chinese M&A market may become more dominated by domestic transactions at least in the short term. However, foreign investment is still an important means to obtain capital.

Considering all these favourable and unfavourable factors, it is estimated that the market will recover very slowly, and it will take some more time before M&As start to boom.

Endnotes

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In Japan, one of the most typical methods to finance leveraged acquisitions is by senior term loans. Senior term loans often consist of multiple tranches designed with some tranches having an amortisation feature, while others have bullet repayment. Depending on the working capital requirements of the target company, a revolving facility may be provided together with the term loans. The lenders are banks, in most cases, while certain non-bank lenders are active in providing senior term loans in the market. Foreign bank branches licensed as such in Japan (see Section II.i for licensing requirements) also occasionally provide leveraged finance. Senior loans are usually secured by security interests over the material assets (including shares in the target company) of the borrower, as well as security interests over the material assets of, and guarantees from, the target company and its material subsidiaries.

Leveraged acquisitions also often utilise mezzanine financing. Mezzanine financing is typically structured as subordinated loans or preferred shares (convertible or non-convertible to common stock), while subordinated corporate bonds are rare. In the recent market where highly leveraged buyouts are often seen, there are sponsors who seek to benefit from higher leverage at the sponsor level of the corporate structure by using mezzanine holdco loans to the parent of the borrower of senior loans.

Year in review

According to a recent research report,[2] the total number of reported leveraged buyouts and the aggregate amount of leveraged financing in Japan were approximately:

1. 47 transactions and ¥241.2 billion in 2015;
2. 61 transactions and ¥387.4 billion in 2016;
3. 66 transactions and ¥1,138.5 billion in 2017;
4. 68 transactions and ¥978 billion in 2018;
5. 81 transactions and ¥750 billion in 2019;
6. 92 transactions and ¥845 billion in 2020;
7. 108 transactions and ¥1,160 billion in 2021; and
8. 120 transactions and ¥1,634 billion in 2022.

Among these, the total number of reported leveraged buyouts utilising mezzanine financing and the aggregate amount of mezzanine financing in those buyouts were:

1. nine transactions and ¥17.5 billion in 2015;
2. eight transactions and ¥14.1 billion in 2016;
3. 13 transactions and ¥48.5 billion in 2017;
4. 15 transactions and ¥1,192.9 billion in 2018;
5. 28 transactions and ¥164.7 billion in 2019;

6. 16 transactions and ¥367.8 billion in 2020;
7. 27 transactions and ¥103.2 billion in 2021; and
8. 23 transactions and ¥176.8 billion in 2022.

After the acquisitions are closed using leveraged finance, refinancing or recapitalisation transactions sometimes take place. These numbers indicate that there is a general increase in the number of leveraged buyouts and growth in deal amounts. When examined closely, the data show three trends:

1. the number of mega deals remains relatively high, which brings up the total deal amount in 2017 to 2022 compared with the preceding years;
2. a proportionate increase in small deals, medium-sized deals and mega deals in 2022, which accounts for a significant increase in both the number and the total deal amount in 2022 compared with the preceding several years; and
3. both the number and the amount of mezzanine financing in 2022 remain basically in line with the average among the preceding years.

Regulatory and tax matters

i Regulatory issues

Licensing

A foreign investor who intends to engage in the money lending business in Japan must be either licensed as a foreign bank branch under the Banking Act of Japan or registered with the relevant authorities under the Money Lending Business Act of Japan (MLBA), unless the money lending in question satisfies an exemption from the MLBA (such as loans to certain affiliates). Both a licensed foreign bank branch under the Banking Act and a registered money lender under the MLBA are required to maintain a place of business in Japan.

Interest regulation

The interest rate for a loan with the principal amount of more than ¥1 million is capped at 15 per cent per annum (on a simple interest basis) under the Interest Rate Restriction Act (IRRA). There are arguments on the interpretation of a 'deemed interest' concept provided in the IRRA,[3] especially on whether certain fees (such as agent fees, arrangement fees and commitment fees) payable to lenders constitute deemed interest. It is generally interpreted that arrangement fees and agent fees do not constitute deemed interest based on the reason that the arranger and the agent provide equivalent underlying services, but in practice many lenders tend to cap the overall costs (including interest rate and fees payable) at 15 per cent per annum. Commitment fees for a credit line (such as a revolving

facility) are expressly exempt from constituting deemed interest if the borrower satisfies certain requirements stipulated under the Act on Specified Commitment Line Contract.[4]

While the interest rate of senior loans has notably increased in an uncertain financial environment after the global covid-19 pandemic, the 15 per cent cap generally does not cause a problem for senior lenders. On the other hand, the cap could be a more sensitive issue for mezzanine lenders because the interest rate of the mezzanine loans, which often contains payment-in-kind interest, is usually calculated on a compounded basis and, when aggregated with upfront fees (on a per annum basis), would be relatively high.

ii Tax issues

Withholding tax

Any interest on a loan payable to a non-Japanese-resident lender is subject to a withholding tax of 20 per cent. This withholding tax may be exempted or reduced to a lower rate pursuant to an applicable tax treaty between Japan and the country in which the lender receiving interest is resident. A loan agreement utilised in the Japanese loan market usually contains a tax gross-up provision to compensate the lender for any loss because of deduction of the withholding tax. In the Japanese leveraged finance market, however, the major issues that are subject to negotiation at the stage of structuring the financing often include whether to permit an offshore lender to be part of the syndication or to be eligible for other permitted assignments under the loan agreement.

Stamp duty

Each original copy of a loan agreement executed in Japan is subject to stamp duty under the Stamp Duty Act of Japan. The amount of stamp duty is determined by the facility amount of the loan agreement, and the maximum amount of stamp duty for a loan agreement is ¥600,000 per original copy. Although nominal, stamp duty in the amount of ¥200 per original copy also arises when executing guarantee agreements in Japan.

Security and guarantees

i Guarantees – upstream guarantees

To avoid structural subordination, lenders typically require upstream guarantees from the target company (and its material subsidiaries) to secure the debts of the acquirer owed to the lenders. Under Japanese law, there are no explicit statutory restrictions on providing upstream financial assistance or corporate benefits that would apply to the upstream guarantee. There is no statutory limitation on the amount of a guarantee, and the usual practice is not to limit the guaranteed amount. If, however, there is any minority shareholder of the target, it is commonly understood that the target providing the upstream guarantee may constitute a breach by the directors of the target of their fiduciary duties. A solution commonly adopted in practice is to obtain consent from all minority shareholders for the upstream guarantee. In a transaction where it is difficult to obtain such consent from all

minority shareholders
(e.g., if the target is a listed company), it is common practice to withhold providing an upstream guarantee until a squeeze-out of minority shareholders is completed.

ii Security interests

Scope of collateral

As collateral in leveraged financing, it is typical for lenders to require:

1. a pledge over shares in the borrower and the target (as well as its material subsidiaries);
2. a pledge over receivables of bank accounts held with lenders; and
3. security interests over other material assets that include, among others, intra-group loans, trade receivables, real estate, movable fixed assets and inventory, intellectual property rights, investment securities, insurance receivables and lease deposit receivables.

Under Japanese law, there is no concept of a blanket security interest over all assets of a person or entity such as a floating charge. Accordingly, a security interest needs to be created individually over each type of asset. The scope of the security package is in principle 'all assets', but the security package is usually negotiated between the parties based on a cost-benefit analysis.

Procedures for creating security interests

For a pledge over shares, other than book-entry shares (such as shares in a listed company), a commonly used method for creating and perfecting the pledge is by delivery of the share certificates to the pledgee. Because this method is only applicable to a company that is classified as a company issuing share certificates under the Companies Act of Japan, if the issuer of the pledged shares is not a company that issues share certificates, lenders often require the issuer to amend its articles of incorporation to become a company that issues share certificates.

For a pledge over, or security assignment of, monetary claims, the security interest that has been created is perfected by either obtaining the consent of debtors of the pledged or assigned claims or registration with the competent authorities. Registration of the pledge or security assignment requires a nominal registration tax. It is legally possible to create a security interest over collective receivables, including current and future claims that are identifiable by types of claim, timing or a period of occurrence and underlying contracts.

For a security transfer of movable assets that has been created, the security transfer is perfected by the transfer of possession or registration with the competent authorities. Registration requires a nominal registration tax. It is also legally possible to create a security interest over collective movable assets that are identifiable by location and type of assets.

For a mortgage over real estate that has been created, the mortgage is perfected by registration with the competent authorities. Registration requires a registration tax in the

amount of 0.4 per cent of the registered secured obligations. A provisional registration (for which the registration tax is a nominal amount) is also available for a real estate mortgage to ensure the ranking of the security interest, provided that subsequent registration is necessary for perfection.

For a pledge over intellectual property rights, the pledge over registered patent rights or trademarks is created and perfected by registration with the competent authorities. Registration requires a registration tax in the amount of 0.4 per cent of the registered secured obligations.

iii Security trusts

Under Japanese law, it has been a commonly accepted doctrine that the holder of the security interest must be the same person as the creditor of the claims that are secured by the security interest. Accordingly, the practice is for each lender to be a secured party in syndicated loan transactions in Japan, because a security agent is not permitted to hold a security interest securing claims owed to these lenders on their behalf.[5] This has been an obstacle to general syndication as an assignment of secured loans requires changes to be made to the security interest already created.

As one possible solution for this inconvenience, an amendment to the Trust Act of Japan was implemented in 2007 introducing the concept of a security trust. This amendment provides for an exception to the above-mentioned doctrine, allowing a trust company licensed under the Trust Business Act of Japan to act as a security trustee that can hold a security interest securing claims owed to lenders. By using the security trust, no individual transfer and perfection procedures for a security interest are necessary when a secured creditor assigns its secured claims, because the security holder will continue to be the security trustee despite the change in the holder of the secured claims. In practice, however, security trusts have not been frequently used for syndicated loan transactions in Japan. This situation is presumably, to some extent, because of the lack of conformity of the security trust system with respect to other relevant laws and actual practices, including the registration procedures required for real estate mortgages. Furthermore, the fact that a large part of syndicated loans are 'club deals' rather than 'general syndications' may also be one of the factors for the less frequent use of security trusts.

iv Parallel debt structure

Another possible option is to use a parallel debt structure, whereby a security agent holds a security interest securing a debt owed by the borrower to the security agent that is created in parallel with the actual debts owed by the borrower to the lenders. While we understand that this is a typical structure used in some jurisdictions, especially where a security trustee structure is not available, we do not see this structure used in the Japanese market except for parallel debt structures governed by non-Japanese law (such as English law or New York law) involving a Japanese-law governed security interest.

One positive move towards utilising the parallel debt structure in Japan is the amendment of the Civil Code of Japan, which came into effect in April 2020. By this amendment, the Civil Code explicitly provides for the concept of joint and several claims among multiple creditors created by a contract that has the features of a parallel debt structure. While it has

been understood, even under the Civil Code before this amendment, that these joint and several claims could be validly created, the feasibility of a parallel debt structure governed by Japanese law has been actively discussed and urged by practitioners. It is anticipated that this amendment to the Civil Code will become an explicit provision that can be relied on to adopt a parallel debt structure in future transactions.

Priority of claims

i Priority of claims upon insolvency

Senior lenders seek to protect the priority of their loan claims in an insolvency scenario of the borrower, typically by use of security interests (against unsecured creditors generally) and subordination arrangements (against subordinated lenders), as further discussed below.

Secured claims, which have priority over unsecured claims in insolvency proceedings, are handled differently depending on the type of insolvency proceeding taking place. In bankruptcy or civil rehabilitation proceedings, secured creditors may enforce security interests outside of the insolvency proceedings without court approval. In corporate reorganisation proceedings, secured creditors are prohibited from enforcing security interests outside of the court proceedings, but will be given priority over unsecured creditors to the extent of the valuation of the collateral.[6]

Subordination arrangements are put in place by contract. There are two possible ways for establishing subordination of claims that are acknowledged in practice. The first approach, which can be typically seen in a case where there exists a shareholder loan along with the senior loan, is by the subordinated lender (the shareholder in this case) agreeing in the subordinated loan agreement between the borrower and the subordinated lender that the subordinated lender will not be entitled to equitable distribution among the creditors in insolvency proceedings until all other unsubordinated claims (including, but not limited to, the senior loan) have been repaid in full. The other approach often used when a mezzanine subordinated loan is utilised, is by the mezzanine lender entering into an intercreditor agreement with the senior lender (typically the borrower is also a party to the intercreditor agreement), stipulating that the mezzanine lender will be subordinated to the senior lender in the order of application of any recovered proceeds among creditors. It is commonly understood that the first method of subordination is recognised by the courts in insolvency proceedings, while the second method would not be binding in insolvency proceedings. Accordingly, when using mezzanine subordinated loans, it is common for the intercreditor agreement to further provide for a turnover provision by which the mezzanine lender is required to turn over any recovered proceeds, including distributions received in insolvency proceedings, to the senior lender so that the priority of the senior lender is subsequently achieved contractually.

ii Key features of intercreditor agreements

In addition to the turnover provision mentioned above, there are certain other provisions seen in intercreditor agreements that protect the seniority of loans. Intercreditor

agreements typically contain provisions for permitted payments to subordinated lenders (the payments for which will be suspended under certain conditions, such as breach of financial covenants) and restrictions on enforcement of certain creditors' rights by subordinated lenders. In terms of the enforcement of creditors' rights, inclusion of enforcement standstill provisions is sometimes negotiated, but not yet commonly used in the Japanese market. One of the major provisions that is often negotiated regarding creditors' rights is the 'deemed consent' provision (and the scope of its exceptions) by which the subordinated lender is deemed to have given consent to certain matters requiring consent by the subordinated lender under the relevant agreement between the subordinated lender and the borrower if the senior lender gives consent to these matters.

It is commonly seen to grant drag-along rights to senior lenders that will, upon enforcement of the pledge over shares in the borrower, entitle the senior lenders to require subordinated lenders to mandatorily sell their subordinated loans to whomever the senior lender designates, including the new purchaser of the shares through the pledge enforcement, which can result in facilitating the sale of the shares in the borrower. The consideration that the subordinated lenders will receive for the sale of their loans will be the remainder of the proceeds generated from the enforcement (if any) after full recovery of the senior loans. In this respect, it is also common to adopt the concept of certain competitive sales processes upon a distressed sale, which is often seen in Loan Market Association-based financing documentation.

Jurisdiction

Japanese courts generally recognise the validity and enforceability of a choice-of-law provision or jurisdiction that is agreed upon by the parties in a loan agreement. In cross-border transactions where non-Japanese lenders or non-Japanese borrowers are involved, the loan agreement is often governed by a law other than Japanese law (such as English law or New York law). The governing law of security documents is generally determined by the jurisdiction in which the collateral assets are located.

Japanese courts also generally recognise a final and conclusive judgment for monetary claims rendered by a foreign court as valid and enforceable, provided that:

1. the foreign court is considered to have valid jurisdiction over the case pursuant to the relevant laws of Japan and treaties;
2. the unsuccessful defendant duly received the service of process necessary for the commencement of court proceedings, other than by public notice or a comparable notice, and in a manner that is not contrary to the provisions of the relevant bilateral or international conventions concerning service of process or, in the absence of receipt, has appeared before the court;
3. the contents and court proceedings of the judgment rendered by the foreign court are not considered to be contrary to the public order or good morals of Japan; and
4. there exists reciprocity as to recognition of foreign judgments between the jurisdiction of the relevant foreign court and Japan.

When the prevailing party enforces a foreign judgment, that party must file a lawsuit in a competent court in Japan to obtain a separate judgment that approves the enforcement of the foreign judgment in Japan. In this lawsuit, however, the merits of the case found in the foreign judgment are not re-examined by the Japanese court.

A foreign investor should note that, in relation to item (b) above, the concept of a 'process agent', which is commonly used in cross-border transactions, is not recognised as valid service of process in court proceedings in Japan. Accordingly, it is possible that a foreign judgment obtained in a lawsuit where service of process is made via a process agent may be considered not to satisfy the requirement of item (b) above and may, therefore, not be enforced in Japan.

Japan is also a contracting country to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention) and, accordingly, a foreign arbitral award can be enforced in Japan in accordance with the provisions of the New York Convention.

Acquisitions of public companies

i Structure of acquisitions of public companies

Outline

A typical structure in Japan for acquisitions of public companies involving acquisition financing is a two-step acquisition comprising a first-step tender offer and a subsequent minority squeeze-out procedure. The acquirer consummates a tender offer to acquire a majority of the issued and outstanding shares in the target company, and thereafter implements a procedure to squeeze out minority shareholders (as explained in detail below). To ensure that the minority squeeze-out can be successfully concluded, in many cases the floor of the number of shares to be acquired in the tender offer is set at two-thirds of the outstanding shares, allowing a special resolution at a shareholders' meeting to be passed.

Reform of squeeze-out structure

Historically, procedures for a squeeze-out of minority shareholders had not been explicitly stipulated in the Companies Act of Japan until an amendment to the Act was enacted in 2015 (the 2015 Amendment). Prior to the 2015 Amendment, practitioners used a complex and time-consuming method for squeezing out minority shareholders by using 'callable shares' combined with a special resolution at a shareholders meeting, which took around three months until the squeeze-out became effective.

The 2015 Amendment offers a more simplified and shortened method for squeezing out minority shareholders compared to the traditional method, namely a cash-out by using a 'conditional call option' exercisable by a special controlling shareholder (as defined below). A person or entity that holds 90 per cent or more of the total voting rights in the target company (the special controlling shareholder), either by itself or together with its

wholly owned subsidiaries, may exercise a conditional call option and thereby demand other shareholders and holders of share options to sell all of their outstanding shares and share options in the target company (other than any treasury shares) to the special controlling shareholder, subject to approval of the board of directors of the target company. After the 2015 Amendment, an acquirer who has acquired 90 per cent or more of the total voting rights in the target company as a result of the tender offer is granted this straightforward method of squeeze-out with only the approval of the target company board required (i.e., without obtaining shareholder approval). This squeeze-out may be concluded within approximately one or two months of the settlement of the tender offer.

Even in cases where the conditional call option is not available (i.e., the shares acquired by the acquirer did not reach 90 per cent), the acquirer who has become a holder of two-thirds or more of the outstanding shares in the target company after the tender offer can now choose an alternative squeeze-out method that has become a recognisable method owing to reforms to the rights of minority shareholders under the 2015 Amendment. The squeeze-out method is conducted through consolidating shares (i.e., reverse stock split) by using a ratio that would result in all minority shareholders (which means shareholders other than the acquirer) becoming entitled to receive only fractional shares (which will be subsequently cashed out with court approval).

ii Acquisition financing for tender offers

Under the current regulations applicable to tender offers, a 'financing out' condition is not allowed for the acquirer. Given that the acquirer is not permitted to withdraw a tender offer because of its financing failure, the acquirer usually obtains a financing commitment letter from the lender prior to the tender offer launch (or, in some cases, enters into a definitive loan agreement).

While the regulations do not explicitly require strict 'certain funds', the competent authorities practically require certainty of the financing. In this regard, under the tender offer regulations, the acquirer is required to disclose a document evidencing the certainty of funds necessary for the settlement of the tender offer via the internet disclosure system of Japan's Financial Services Agency (FSA) named the Electronic Disclosure for Investors' NETwork (EDINET). In an acquisition financing, it is typical to disclose a summary commitment letter issued by the lender to the acquirer.[7] The terms of the letter are usually based on the major terms and conditions agreed in the long-form commitment letter (or, if available, the definitive loan agreement), but it is not practically required to disclose the economic conditions such as margins and fees.

If a fund formed as a partnership is to provide debt or equity financing to the acquirer, the authorities may in practice seek verification regarding the availability of a capital call, including the required funding by limited partners upon this call.

Outlook and conclusions

Almost two decades have passed during which buyouts driven by private equity funds have become popular in Japan, and the market practice of leveraged finance has become well established. During the development of the market, financing needs in leveraged acquisitions have become diversified, leading to a variety of leveraged buyout or leveraged

finance structures being utilised, such as mezzanine holdco loans, subscription facilities and recapitalisation by way of a trade sale or dividends.

In recent years, major global private equity funds have been actively investing in Japan with their operations localised to some extent. Along with their expanded presence, there has been the need for transactions to adopt features of global leveraged finance, such as a 'certain funds' concept (especially in bid transactions) that was rarely seen under traditional banking practice in Japan.

Other notable recent trends of M&A in Japan include the increasing number of carve-out transactions in traditional manufacturing and service industries, and horizontal integration including through roll-up acquisitions. M&A transactions for the purpose of business succession from founders or the founder family remains approximately one-half of the total number of buyout transactions in Japan in recent years. Joint investment by private equity funds and strategic enterprises or other private equity funds have also become popular. The diversification in acquisition structures affects financing structures for these acquisitions and is driving acquisition financing to continue being a vibrant and fast-growing practice area in Japan.

Since 2020, the global covid-19 pandemic has had a significant impact on existing leveraged financing where many portfolio companies faced a financial crisis and required financial covenant waivers or emergency credit facilities from bank lenders. Some of those companies, which include one of the largest-scale leveraged financings in Japan, have been forced into bankruptcy or civil rehabilitation proceedings. After a temporary downturn in M&A transactions across Japan during the first half of 2020, private equity funds have restarted and remain actively engaged in leveraged buyout transactions, both private and public. Even so, financial terms including the minimum equity requirement, interest margins, upfront fees and financial covenants offered by lenders have become more stringent compared with pre-covid years owing to ongoing economic uncertainty and lenders' limited risk tolerance.

Endnotes

1 Satoshi Inoue, Yuki Kohmaru and Hikaru Naganuma are partners at Anderson Mori & Tomotsune. ^ Back to section

2 See Japan Buy-out Research Institute Corporation, *Yearbook of the Japan* Buy-out-*Market* – [Second half, 2022], pp. 138–139 (2023). ^ Back to section

3 Under the IRRA, any money other than the principal, however described, received by a lender regarding a loan will be deemed to constitute interest, except for expenses in connection with the execution of the contract or performance of the obligations. ^ Back to section

4 The typical requirements are, among others, that at the time of entry into the loan agreement, the borrower is a joint-stock company satisfying any of the following: its stated capital being more than ¥300 million; its net assets (on an unconsolidated basis) being more than ¥1 billion at the end of the latest financial year; or the debt reported on its balance sheet being ¥20 billion or more at the end of the latest financial year. Because a leveraged buyout borrower is in most cases a newly established company, the stated capital of more than ¥300 million is typically required at the time of entry into the loan agreement. ^ Back to section

5 An agent under the common practice in Japanese syndicated loan transactions has the role of administrative work only, such as delivery of documents and notices, confirmation and communication of majority lenders' instructions, paying agency work and other ministerial work relating to the enforcement of lenders' rights, including in connection with security interests. ^ Back to section

6 Unsecured claims are usually treated as general claims in insolvency proceedings that will receive pro rata distribution only after the aforementioned treatment of the secured creditors. ^ Back to section

7 According to guidance issued by the FSA, the FSA requires that a summary of conditions precedent to the financing be described in such letter, and that the acquirer or the lender engage in a prior consultation with the competent authorities delegated by the FSA to verify the certainty of the financing. ^ Back to section

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Introduction

In Spain, as in many other jurisdictions, financial markets have struggled in 2022 and 2023 as a result of interest rates rising at one of the fastest paces on record, inflationary pressures, increase in electricity prices and macroeconomic uncertainty.

Heightened geopolitical tensions and concerns over the prospect of a global recession have all continued to weigh on the market. Moreover, the government may have a short-term focus due to the political instability caused by a weak coalition government, discourse in the European Union and upcoming general elections.

Spanish M&A and private equity deal volume has experienced a slowdown in Spain during 2023, impacting lending activity in the country. High-yield issuance and leveraged loans for M&A and leveraged buyout (LBO) deals in Spain have considerably reduced, with amend and extend processes dominating leveraged finance volumes in 2023 as borrowers and issuers look to tackle upcoming maturities amid the uncertain macroeconomic outlook. The recent reform of the Spanish Insolvency Law will significantly increase the number of company restructurings. Proposed reform will bring about a new way of performing M&A, enabling funds and holders of debt to acquire equity interest in impaired companies.

Inflation and higher interest rates will continue to affect economic growth. Overall, GDP growth is expected to reach 2.2 per cent in 2023 and 1.9 per cent in 2024. Inflation is expected to continue to decline over the forecast horizon reaching 3.6 per cent in 2023 and 2.9 per cent in 2024.

Year in review

Although Spain has continued to be an attractive destination for investment, geopolitical tensions, macroeconomic uncertainty, rising interest rates and inflationary pressures have created wider ambiguity within the syndicated debt and capital markets during 2023, resulting in lower deal volume as compared with the previous 24 months.

While M&A-linked debt issuance suffered a slowdown in 2023 due to the challenging market conditions, other providers such as private capital providers, private debt funds and international banks have stepped into the market to fill the void left by underwriting banks and local lenders.

Due to inflation and higher interest rates, private capital providers have gained market share in Spain, thereby providing innovative solutions for companies seeking to manage their balance sheets and liabilities and securing liquidity amid the increasing cost of debt. In line with this, the market is witnessing an increase of amend-to-extend transactions, which gives sponsors with credits approaching maturity the opportunity to amend and extend the existing debt tranches or exchange offers. These types of deals will offer lenders a consent fee, higher coupon in bonds issuances for extending loan maturities by 12 to 24 months and more covenant protections or additional credit support.

Regulatory and tax matters

i General regulatory requirements

Generally, no regulatory permits or authorisations are required to act as a lender or security agent in acquisition finance deals in Spain. However, certain regulatory authorisations and registrations may be required to act as a credit entity for consumers according to Law 2/2009 of 31 March 2009, which regulates contracting with consumers for mortgage loans or credits and intermediation services for concluding loan or credit contracts, and Law 5/2019 of 15 March, which regulates real estate credit contracts.

ii Sanctions and anti-money laundering

Sanctions

As a member of the European Union and United Nations, Spain follows the sanctions imposed by the Security Council of the United Nations and by the EU authorities under the Common Foreign and Security Policy.

AML regulations

Anti-money-laundering (AML) regulations in Spain require that, prior to initiating any business relationship, the ultimate beneficial owner (UBO) of the parties involved in the deal must be clearly identified.

For legal entities, the UBO is defined, in simplified terms, as the natural person who ultimately owns or controls, directly or indirectly, more than 25 per cent of the share capital or voting rights of the legal person, or who by other means controls, directly or indirectly, the management of a legal person.

If a particular legal entity has no UBO, the Spanish anti-money laundering laws presume that the control is exercised by the directors and, therefore, their personal details should be disclosed. If a director is a legal person, the personal details of its representatives (or directors) should be disclosed.

These requirements are of particular significance in Spain because, while notarisation of a loan document is not required by law, notarisation affords the lenders material enforcement advantages. As such, it is market practice to do so. In addition, as a general rule, Spanish security interests must be notarised. In any case, it is market practice to do so. A notary may refuse to grant the relevant deed if there is any failure to satisfy these UBO requirements.

iii Regulations of foreign investments in Spain

Act 19/2003 of 4 July on the legal framework of capital movements and foreign economic transactions and its associated regulations establish the regime for foreign direct investment (FDI) in Spanish companies.

Traditionally, Spain's FDI regime only applied in relation to investments directly related to Spanish national defence. However, in March 2020, within the covid-19-related measures adopted by the Spanish government, Act 19/2003 was amended to include a broader FDI screening regime (Article 7*bis*). Act 19/2003 has been recently developed by Royal Decree

571/2023 of July 4 on foreign investments, which clarifies the scope of application of the Spanish FDI regime.

Pursuant to Article 7*bis*, transactions over €1 million that allow the foreign investor to directly or indirectly reach ownership of 10 per cent or more of the shares of a Spanish company or attain control of the Spanish company as understood under antitrust regulations, may require prior authorisation. This prior authorisation is required only if:

1. the target carries out activities that may affect public order, public security or public health in certain sectors that are considered strategic (strategic sectors); or
2. regardless of the sector of the target, the foreign investor meets certain characteristics (qualified investors).

Foreign investors include investors resident outside the European Union and the European Free Trade Association and investors resident in the European Union and the European Free Trade Association whose UBO is a non-EU or non-EFTA investor. Ownership by the UBO is understood to exist if it holds, directly or indirectly, a stake above 25 per cent of the share capital or voting rights of the company making the investment, or when the UBO exercises control by any other means.

Transitorily, and until 31 December 2024, the regime has been extended to investments carried out in the strategic sectors by investors resident in the European Union and the European Free Trade Association provided that the Spanish target is listed in a Spanish official secondary market (regardless of the value of the transaction) or if it is a non-listed Spanish target company, to the extent that the value of the transaction is greater than €500 million.

Strategic sectors include:

1. critical infrastructure (physical or virtual);
2. critical technology and dual-use products and key technologies for industrial leadership and training and technologies developed under projects or programmes that are of particular interest to Spain;
3. supply of critical inputs, in particular energy, fossil fuels and raw materials, as well as food supply and strategic connectivity services;
4. sensitive information, including access or control of personal data under the General Data Protection Regulation (EU) 2016/679; and
5. media.

Qualified investors are those who:

1. are directly or indirectly controlled by a government of a third country, including state bodies, sovereign funds or armed forces;
2. have made an investment or have already been involved in activities affecting security or public order in an EU Member State and in particular in the sectors listed above; or
3.

pose a risk of carrying out criminal or illegal activities affecting public order, public security or public health.

The review period for the authorisation is three months.

Investments carried out without the required authorisation will be considered invalid and with no legal effect in Spain, pending clearance. Additionally, the foreign investor may be fined. The sanction may reach the full value of the transaction.

While FDI approval is principally a matter of concern from an M&A perspective, it is also relevant in a debt finance context as this approval may be required to enforce security documents granted directly or indirectly over the shares of Spanish companies.

iv Tax matters

Deductibility of interest

Spanish corporate income tax (CIT) law does not provide for a thin capitalisation regime, but has an interest-stripping regime limiting the deductibility of net interest expenses to 30 per cent of adjusted operating profits (roughly speaking, earnings before interest, taxes, depreciation and amortisation (EBITDA)) in a given fiscal year, with a €1 million floor. The excess difference could benefit from a carry-over for an indefinite period. Where a taxpayer incurs net interest expenses not exceeding the €1 million floor, the difference between the interest cost and the floor amount will increase the applicable 'cap room' in the five subsequent years. These rules must be tested at a group level where the Spanish borrower belongs to a Spanish fiscal unity (subject to the anti-LBO rules described below).

The existence of a Spanish fiscal unity could have certain advantages. In general, a leveraged holding company may be able to shelter taxable income obtained by its subsidiaries belonging to the Spanish fiscal unity against interest expenses incurred at the holding company level.[2]

The Spanish interest-stripping rules are in line with the conclusions of Action 4 of the Base Erosion and Profit Shifting initiative.[3] These rules were recently amended (with effects from the fiscal year starting on 1 January 2024) to ensure their compatibility with the interest limitation rule provided under the EU Anti-Tax Avoidance Directive adopted by the Council of the European Union in July 2016.

Among the amendments to the Spanish rules outlined above that will enter into force from the fiscal year 2024, the most relevant is the fact that dividends benefiting from the Spanish participation exemption regime will no longer be treated as additional EBITDA for purposes of the interest-stripping regime. Another noteworthy development is the inclusion of securitisation funds in the scope of the regime. Currently, securitisation funds are deemed similar to financial entities and insurance companies and, therefore, are not subject to the interest deductibility limitations.[4]

Other features of the Directive have not been adopted by the Spanish legislator, such as an increase of the minimum interest deductibility floor up to €3 million, the introduction of safe harbours to public infrastructure financing projects and the introduction of a consolidated group ratio rule.

On the other hand, there are certain anti-abuse rules that may limit the availability of interest deductions within a fiscal unity or upon a post-acquisition merger. For instance, an anti-LBO rule imposes an additional limitation to the deductibility of interest accruing on debt incurred to make acquisitions of shares. Under this rule, where the bidco vehicle and the target company merge or form a fiscal unity in the four years following the acquisition, the above-mentioned 30 per cent EBITDA limitation should be tested taking into account only the bidco's stand-alone EBITDA and not the fiscal unity's (or the EBITDA corresponding to the merged entity, as the case may be). To the extent that the bidco is a special-purpose vehicle set up for purposes of performing the shares acquisition (and not an operating entity), this rule would, in practice, prevent acquisition interest from being tax deductible.

To dispel allegations that the anti-LBO rule puts private equity firms at a disadvantage as regards industrial groups, the Spanish lawmaker introduced an 'escape clause' to the anti-LBO rule, whereby the additional 30 per cent limitation would not apply if:

1. the level of leverage does not exceed 70 per cent of the purchase price of the shares acquired; and
2. the acquisition debt is reduced on a proportionate basis within the eight years following the acquisition, until the debt reaches a threshold of 30 per cent of the purchase price.[5]

Where the acquisition is financed through different kinds of loan facilities (e.g., junior, senior, mezzanine, vendor loans or other types of loans), the amortisation required under the anti-LBO rule may be performed in any of such facilities, provided that the combined outstanding principal amount of all of them does not exceed the maximum threshold for the year in question.[6] On the other hand, the indebtedness existing at the target company prior to its acquisition does not appear to fall under the scope of this rule.[7]

In addition, there are other anti-abuse rules under Spanish tax law that may limit the deductibility of interest incurred by a Spanish borrower. Interest expenses arising in connection with intragroup debt, where that debt is used to acquire shareholdings from other group entities or to perform equity contributions into other group entities are non-deductible, unless the borrower is able to evidence to the Spanish tax authorities that there are sound business reasons for the transactions.[8] Furthermore, interest accruing on profit-participating loans (PPLs) granted by group entities and interest giving rise to hybrid mismatches[9] are also non-deductible. Spanish transfer-pricing rules may also be used by the Spanish tax authorities to challenge interest deductibility in a related-party loan and to reclassify debt instruments into equity instruments (depending on the features of the instrument). The deductibility of interest incurred in connection with debt financing an equity distribution to the shareholders of the borrower entity (e.g., a dividend recap) should be reviewed on a case-by-case basis.[10]

Withholding tax

General rules

From a practical perspective, it is standard for foreign lenders to use EU-based vehicles to make loans to Spanish borrowers, as it is not market practice for borrowers to gross-up interest withholding tax (WHT) levied on payments made to lenders who are not 'qualifying lenders' (i.e., lenders entitled to an interest withholding exemption). As a general rule, payments of Spanish-sourced interest are currently subject to WHT at a 19 per cent rate. Tax haven-based lenders will be subject to this standard WHT rate. EU- and EEA-based lenders (or EU and EEA permanent establishments of EU- and EEA-based lenders)[11] may receive interest free from Spanish WHT, subject to the fulfilment of compliance requirements (e.g., holding a valid government-issued tax residence certificate, or certain alternative certification requirements applicable to pension funds, collective investment vehicles and alternative investment funds). Spanish-resident registered banks, registered Spanish permanent establishments of foreign banks and Spanish securitisation funds also benefit from the WHT interest exemption. Finally, certain tax treaties entered into by Spain may also provide for a WHT exemption on interest (e.g., the tax treaties entered into with Switzerland, the United Kingdom (which place UK lenders in a similar position to EU lenders following Brexit) and the United States), also subject to the fulfilment of compliance and specific eligibility requirements.

Anti-abuse

Spanish tax law does not provide for a definition of 'beneficial owner' in respect of interest. In fact, the above-mentioned rule exempting interest payments made to EU lenders from WHT does not provide for a 'beneficial ownership' provision. Notwithstanding this, the Spanish domestic rule derives from the transposition of Council Directive 2003/49/EC (the Interest Directive) and the Court of Justice of the European Union (CJEU). The CJEU has analysed in the 'Danish cases' (C-115/16, C-118/16, C-119/16 and C-299/16) the concept of 'beneficial owner' under the Interest Directive, and concluded that the notion of beneficial owner (to be interpreted in a way consistent with the OECD standards) may be applicable by Member States regardless of the inclusion of a beneficial ownership requirement in the domestic laws. The Spanish Economic-Administrative Court (TEAC), in a resolution dated 8 October 2019, echoed the Danish cases and concluded that the Spanish interest WHT exemption can only be claimed by the beneficial owner of the interest. There is still uncertainty as regards to how this doctrine, as applied by the Spanish tax audit, will be interpreted by the Spanish courts of law. However, given the scope of the Danish cases (which addressed related-party lending structures and no third-party financing structures) and the background of the Spanish exemption rule, which apply regardless of the existence of borrowing between associated entities (and therefore go beyond the scope of the Interest Directive), there are grounds for supposing that the impact of this doctrine might be limited in the context of third-party lending. In any event, back-to-back lending structures, shareholder loan financings and sub-participation arrangements should be carefully reviewed in light of these precedents and of anti-abuse principles generally. An assessment of the robustness of a lending structure against such potential challenges must be carried out on a case-by-case basis.

Special regime for notes offerings

Spanish tax law provides for a special tax regime[12] applicable to, among others, qualifying notes offerings made by Spanish-resident companies and by wholly owned subsidiaries

of Spanish companies resident within the European Union,[13] provided that certain additional requirements relating to the offering (e.g., the listing of the notes on a suitable exchange) are met, and certain compliance information is timely supplied by the paying agent involved. This regime provides for a WHT interest exemption on payments made to all foreign noteholders, regardless of their jurisdiction of residence (i.e., tax-haven investors are not penalised) and without requiring individualised tax documentation (such as government-issued tax residence certificates) to be supplied.

Horizontal tax groups

The tax consolidation regime for Spanish companies income tax (CIT) purposes mandatorily includes within a tax group the Spanish subsidiaries of a common non-Spanish resident parent company,[14] allowing the formation of a horizontal tax group that would include all Spanish-resident direct or indirect subsidiaries in respect of which such ultimate non-Spanish parent company had a qualifying shareholding (i.e., generally, 75 per cent of share capital and majority of the subsidiary's voting rights). The wording of the law (and, in particular, the rules governing the formation of horizontal tax groups) creates several pitfalls that may affect a wide array of industries (e.g., multinational groups with Spanish investments, private equity sponsors and financial institutions financing Spanish acquisitions).

For instance, under the horizontal group rules, a multinational group's parent company holding indirect investments in different businesses without any relationship whatsoever among them from an organisation standpoint (which is a fairly common situation in multinational conglomerates) could be deemed to be the parent company of a sole fiscal unity that should be automatically formed by all the Spanish entities it owns. Under the Spanish CIT Act provisions (which have already been interpreted by the Spanish tax authorities),[15] if these indirect Spanish subsidiaries already formed their own tax groups in Spain, one of the pre-existing tax groups should cease to exist, with the de-grouping charges that could derive from the termination (i.e., recapture of certain intra-group gains that were eliminated in the past owing to the applicability of the consolidated tax regime). Spanish law does not, however, determine which tax group should be terminated.[16]

Another example of unwarranted implications of the horizontal group rules may be followed in private equity structures. Generally, private equity sponsors have 'master' holding companies in an EU jurisdiction and make leveraged buyout acquisitions through Spanish bidco vehicles partly financed through loans granted by financial institutions. Once the Spanish bidco acquires the shares of the Spanish 'target' company, bidco and target generally form a tax consolidated group. In these structures, the second Spanish investment made indirectly from the same master holding company (with the same bidco–target structure) may turn out not to be eligible to form a stand-alone tax consolidated group. The fact that there is a common parent company for both the first bidco and the second bidco would mean that the entities related to the second acquisition (i.e., the second bidco and the second target group) should form a single horizontal tax group.

Such an unwarranted outcome may be a great inconvenience for the private equity sponsor (as the financial models prepared for the first acquisition – taking into account the features of the first target and the first bidco's leverage level – may be significantly changed)[17] and for the financial institutions (as the formation of a horizontal tax group may imply

an additional exposure to tax risks associated with companies that did not fall under the perimeter of the acquisition that was financed).[18]

While there may be strategies to structure investments to avoid the adverse implications of this regime,[19] their implementation requires individualised tax advice.

Security and guarantees

i Parallel debt

Parallel debt structures governed by Spanish law are not used in the Spanish market, as there is a risk of their being declared null and void pursuant to the Civil Code owing to the absence of a legal consideration supporting the creation of such autonomous, independent and abstract debt. Moreover, the legal concept of trust is not regulated under Spanish law. Therefore, it is not court-tested whether a security agent under a syndicated finance deal would be able to validly hold any debt or security interest on behalf of the lenders acting as trustee pursuant to a parallel debt structure. Accordingly, the relevant security interest must be granted in favour of each and every secured party. That being said, parallel debt structures have been recently recognised in other civil law jurisdictions (e.g., France); therefore, the possibility of future changes in Spain cannot be disregarded.

ii Limits to guarantees and security interests of Spanish guarantors

Limitations on guarantees provided by Spanish guarantors incorporated as SLs

Spanish guarantors incorporated in the form of *sociedades de responsabilidad limitada* (SLs) can only issue notes up to an aggregate maximum amount of twice its own equity, unless the issue is secured by a mortgage, a pledge of securities, a public guarantee or a joint and several guarantee from a credit institution. It is not fully clear if this limitation on SLs applies to the granting of guarantees or security interests in favour of notes.

Financial assistance

When structuring acquisition finance deals or refinancing previous acquisition finance deals, it is important to bear in mind that neither SLs nor *sociedades anónimas* (SAs, which are the most common form of big Spanish corporations) may secure or guarantee, or participate, help or render any sort of financial assistance for the acquisition of their own shares or quotas, or those of their parent companies. Furthermore, SLs may not secure or guarantee, or participate, help or render any sort of financial assistance for the purchase of the shares or quotas of any company within their group. Any security interest or guarantee that constitutes unlawful financial assistance in accordance with the foregoing rules is null and void. Additionally, financial assistance may raise civil liability issues for the directors and, potentially, may be a criminal offence.

Unlike English law, Spanish law does not regulate a whitewash procedure and, therefore, in the past the traditional way to avoid financial assistance was the 'forward merger' between

the bidco and the target, which should be backed by a valid economic reason for the merger to benefit from an advantageous tax regime.[20] Royal Decree-Law 5/2023 of 28 June, which approved a new regime on structural modifications, maintains the specific regulation to leveraged mergers consisting of a merger between two or more companies where any of them has incurred debt in the three years prior to the merger to acquire control of any of the other companies involved in the merger or to acquire assets of any of the other companies involved in the merger that are essential for normal operation or are significant for the equity value of the company. In this scenario, the following rules apply:

1. the merger plan will specify the resources and terms envisaged for payment by the resulting company of the debts incurred for the acquisition;
2. the directors' report on the merger plan must indicate the reasons that justify the acquisition and, if applicable, the merger. The directors' report must also contain an economic and financial plan setting out the resources and providing a description of the objectives to be achieved; and
3. the experts' report on the merger plan must contain an opinion on whether the aforementioned information is reasonable.

According to Article 42 of Royal Decree-Law 5/2023 of 28 June, an independent expert (appointed by the relevant mercantile registry) is no longer required to render an opinion on whether financial assistance exists.

Nowadays, the usual approach is to assume that these restrictions also apply to a refinancing of debt incurred in connection with a previous acquisition.

While there are practitioners that consider that the Spanish financial assistance limitations applicable to Spanish companies should be extended to foreign subsidiaries, the extra territorial application of the Spanish financial assistance limitations is usually not the approach followed by the market.

iii Limitations on security and guarantee

The corporate benefit concept is not expressly recognised under the Spanish legal system. Nonetheless, several points should be borne in mind:

1. if a Spanish company grants security interest or guarantees where the transaction pursuant to which the security interest granted is not found to result in the ultimate corporate benefit (direct or indirect) of said company, the directors of that company could be in breach of their fiduciary duties; and
2. to the extent that the power to grant security interest or a guarantee for the benefit of third parties is not included in the directors' powers, the directors may need to seek a special authorisation from the company's shareholders.

Under the Spanish Insolvency Act,[21] any agreement entered into by a Spanish company within the two-year period immediately preceding the petition of insolvency or the notice of the initiation of negotiations with the creditors or the intention to initiate them to reach a restructuring plan (as well as the agreements entered into between any of the

aforementioned events and the declaration of insolvency by the relevant commercial court) may be rescinded by the relevant insolvency court, provided that the insolvency receiver deems that the terms of the agreement are detrimental to the insolvent estate, even if there was no fraudulent intention. Likewise, any agreements entered into by a Spanish company within the two-year period immediately preceding the date of the communication of existence of negotiations with its creditors, or the intention to commence such negotiations, to reach a restructuring plan pursuant to Articles 585 et seq of the Spanish Insolvency Act may be also rescinded (even if there was no fraudulent intention) unless:

1. it is not approved as a restructuring plan or being approved it is not homologated by the competent court; and
2. the insolvency is declared within the year following the end of the effects of the aforementioned communication or of the extension that would have been granted.

In addition to the foregoing, the Spanish Insolvency Act contains a presumption by virtue of which it will be deemed detrimental to the insolvency state, and therefore it will be declared null and void, any *in rem* security granted, within the clawback period, as collateral for either an existing obligation or a new obligation in replacement of an existing one.

However, any security interest and guarantee granted within the context of a homologated restructuring plan will not be subject to the aforementioned presumption, to the extent that the relevant restructuring plan affects at least 51 per cent of the total liabilities of the debtor, unless it is proven that the security interest was granted in fraud of creditors.

In view of the above, corporate upstream guarantees may be challenged to the extent that they do not result in a tangible and identifiable interest to the guarantor beyond the abstract group interest.

In a non-insolvency situation, the corporate benefit requirement still applies. However, it does not need to be quantified, and it will not prevent a guarantee from covering working capital facilities that are not linked to the acquisition of the company's or its holding company's shares or quotas.

SLs must obtain their shareholders' approval prior to providing security or guarantees in favour of their shareholders or directors, unless the beneficiary of the security or guarantee, as applicable, is a company that belongs to the same group of companies.

Although there are some practitioners that understand that the shareholders' meeting must approve the granting of security interest over assets that may be considered essential for the company, there is no market standard in this regard. However, this is typically seen as a condition precedent in the framework of LBOs in Spain.

iv Security

The most typical securities in the Spanish market are real estate mortgages and pledges over shares or quotas,[22] bank accounts and credit rights. Promissory mortgages are also not unheard of in the Spanish market, although they may not be considered security interest but just an undertaking to create security interest.

A universal floating catch-all security interest, similar to an English law debenture or US Uniform Commercial Code security interest, is not recognised under Spanish law. In contrast, each security interest over an asset class is documented in a separate deed and signed before a notary public. In this sense, Spanish law security documents must accurately describe the assets that are subject to a particular charge.

The possibility of creating a single global pledge to secure multiple liabilities is not expressly regulated by the Spanish Civil Code; however, there are grounds to sustain the validity of security interests and guarantees being granted in respect of multiple liabilities. Royal Decree 5/2005, for example, allows for the creation of a single financial security interest to secure several obligations. The use of global real estate mortgages to secure multiple liabilities is also recognised and regulated by Article 153*bis* of the Spanish Mortgage Law dated 8 February 1946. Lastly, the use of personal guarantees to secure multiple liabilities was expressly recognised by Article 98 of Spanish Royal Decree Law 3/2011 of 14 November, which approved the Consolidated Text of the Public Sector Contracts Act. However, Article 98 of the former Public Sector Contracts Act was repealed by Act 9/2017 of 8 November, which approved the new Public Sector Contracts Act that entered into force on 9 March 2018. As a consequence of the above, there are also grounds to sustain the validity of global pledges, even though a different view from the competent courts cannot be disregarded.

Mortgages

As a general rule, pursuant to the principle of speciality, each mortgaged asset may secure the obligations arising from one debt instrument only. However, when all lenders are financial entities (as defined in Article 2 of the Spanish Mortgage Market Act)[23] and certain formal requirements are also met, the relevant mortgage may be created in the form of a maximum liability mortgage, which may secure several present or future obligations arising from debt instruments up to the said maximum liability.[24]

Spanish law mortgages can be created over real estate assets and over movable assets such as intellectual property rights, industrial machinery, aircraft, vehicles and business premises; as a perfection requirement, they must all be registered with the relevant public registry.

The mortgage deed must expressly mention, among others, the maximum amount of the underlying obligations that is secured by the mortgage. In this sense, it is important to carry out a cost-benefit analysis, given that stamp duty must be paid on the basis of the maximum secured amount. Currently, the stamp duty applicable to public deeds of mortgage may generally range between 0.5 and 2 per cent of the secured amount (depending on the region where the asset is located).

Since November 2018, following a long court controversy regarding the party who should be liable for stamp duty upon the grant of a mortgage loan, the Spanish government enacted legislation shifting taxpayer status to the lenders, regardless of the type of loan, the status of the lender (bank or otherwise) or the status of the borrower (e.g., consumer, individual or corporation). From a practical standpoint, however, lenders often demand that borrowers contractually bear the cost of stamp duties, although lenders will continue being liable for such payment before the Spanish tax authorities.

Assignments of commitments under the relevant facility agreement between lenders do not automatically result in the assignment of the assigning lender's participation in the mortgage. The assignment of the mortgage must be expressly documented and registered with the relevant public registry for the acquiring lender to become a mortgagee of record. Furthermore, stamp duty is levied based on the commitment being transferred.

The mortgage deed must include the Spanish tax identification numbers of all parties to enable the Spanish authorities to identify each party thereto.

Pledges

As stated above, Spanish law does not expressly regulate the possibility of creating a single global pledge to secure several obligations. However, Royal Decree 5/2005 allows the creation of single financial security interest to secure several obligations and global real estate mortgages are expressly regulated by Article 153*bis* of the Spanish Mortgage Law dated 8 February 1946. In this sense, based on the acceptance of the application by analogy of the mentioned regulations, it is a widespread market practice to grant a single global pledge to secure several obligations, which is generally considered acceptable in Spanish academic literature.

There are two main types of pledges under Spanish law: pledges with transfer of possession and pledges without transfer of possession.

Pledges with transfer of possession

Pledges with transfer of possession require the possession of the pledged asset to be transferred to the creditor or to a third party for the purposes of perfecting the pledge. For assets that are not physically transferable, there are presumptions that certain actions (e.g., granting the pledge as a Spanish deed and delivering notices) are equivalent to transferring possession of the relevant asset.

Under certain circumstances, pledges with transfer of possession may be subject to RDL 5/2005,[25] which incorporated the European Financial Collateral Directive[26] into Spanish law and aims to facilitate the enforcement of financial collateral arrangements. To benefit from this regime, the following requirements, among others, must be met:

1. at least one of the parties must be a public entity, a central bank, a credit institution, an investment services company, an insurance company, a real estate collective investment undertaking or any of its management companies, mortgage securitisation funds, asset securitisation funds or any of the management companies of a securitisation fund, pension fund or other financial institution, as defined in Article 3(22) of Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 or secondary market bodies and management companies of those secondary markets, clearing system companies, entities referred to in Law 41/1999, and equivalent entities operating in the options, futures and derivatives markets;
2. the pledged asset must be cash (i.e., the money credited to an account in any currency), marketable securities[27] and other financial instruments, or specific

receivables (i.e., money claims arising out of an agreement whereby a credit institution grants credit in the form of a loan agreement or a credit line); and

3. the financial collateral arrangement must have been formalised in writing.

The main advantages of RDL 5/2005 for lenders are as follows:

1. no formalities (e.g., registration and notices) are required other than documenting the arrangement in writing, the provision of the collateral, to either the beneficiary or any person acting on its behalf, and constancy of such provision in writing or in a legal equivalent manner;
2. it allows for the direct sale or appropriation of the pledged asset;
3. it provides certain protections against insolvency, given that the initiation of insolvency proceedings is not considered sufficient grounds to declare null or to rescind or to suspend the enforcement of a financial collateral arrangement; and
4. compensation agreements subject to RDL 5/2005 will not be affected by a declaration of insolvency.

In light of a judgment issued by the CJEU on November 2016,[28] there is a risk that a pledge over bank accounts may not qualify as a financial collateral arrangement if the account holder may freely dispose of the monies deposited in the account. This does not mean that pledge would become null or unenforceable, but that the relevant beneficiary would not benefit from the advantages provided by the RDL 5/2005 for the financial collateral arrangements.

Finally, certain Spanish regional rules may apply depending on where the pledged assets are located.

Pledges without transfer of possession

Pledges without transfer of possession do not require the possession of the pledged asset to be delivered. However, they must be registered in the relevant movable assets registry as a perfection requirement.

Unlike mortgages, provided the pledge is granted as a Spanish commercial deed and not as a notarial deed, no stamp duty will be levied, but it attracts certain other costs such as notarial and registration fees. However, the deed of pledge must still include a reference to the maximum amount of obligations that is secured by the pledge without transfer of possession. Spanish tax identification numbers are required to have the pledge registered.

As regards assignments between lenders, similarly to mortgages, the assignment of a lender's position under a pledge without transfer of possession must be expressly documented and registered with the relevant public registry.[29]

Similar to pledges with transfer of possession, Spanish regional rules may apply depending on where the pledged assets are located.

Market participants structure pledges over credit rights as pledges with transfer of possession to avoid registration requirements.

Promissory mortgage

Promissory mortgages are not unusual in Spanish finance deals. A promissory mortgage does not create an *in rem* right of mortgage, but rather an obligation for the grantor in relation to the relevant lenders party thereto to create an *in rem* right of mortgage upon the occurrence of the agreed trigger event.

Promissory mortgages are typically used when the amount of stamp duty that would be levied on the relevant mortgage deed is too large compared with the risk of default or, generally, with the benefit of creating a mortgage upon closing a deal.

In any case, lenders should bear in mind that the conversion of the promissory mortgage into a legal mortgage requires the payment of the stamp duty that was initially avoided, and that it entails significant insolvency limitations and a rescission risk.

Irrevocable powers of attorney

It is usual in the Spanish market to have the mortgagor or pledgor grant a special power of attorney in favour of the security agent (or even the secured parties) to carry out certain actions on its behalf. Pursuant to an irrevocable power of attorney, the security agent is typically authorised to carry out perfection, further assurance and enforcement actions on behalf of the relevant mortgagor or pledgor with respect to the relevant security documents. To ensure that the mortgagor or pledgor may not unilaterally revoke the power of attorney, the security agent is usually party to the deed of power of attorney, and certain specific language is included.

It is worth mentioning that the scope of the powers granted in favour of the security agent or secured parties should be carefully defined to avoid their potential classification as shadow directors in an insolvency proceeding of the grantor.

Finally, under Spanish common law, powers of attorney, appointments or authorisations granted, regardless of whether they are stated to be irrevocable, are generally revocable by the grantor, provided that the revocation is in good faith. Moreover, irrevocable powers of attorney become unenforceable in insolvency.

Priority of claims

i Types of claims

Once insolvency has been declared, the court receiver draws up a list of acknowledged claims and classifies them according to the following categories.

Claims against the insolvency estate

These claims are payable when due according to their own terms (and, therefore, are paid before all other claims under insolvency proceedings – see below). Claims against the insolvency estate include:

1. a certain amount of the employee payroll;
2. the costs and expenses of the insolvency proceedings;
3. certain amounts arising from services provided by the insolvent debtor under reciprocal contracts and outstanding obligations that remain in force after insolvency proceedings are declared, and certain amounts deriving from obligations to return and indemnify in cases of voluntary termination or breach by the insolvent debtor;
4. amounts deriving from the exercise of a clawback action during the insolvency proceedings regarding certain acts performed by the insolvent debtor and corresponding to a refund of consideration received by it (except in cases of bad faith);
5. certain amounts arising from obligations created by virtue of law or from tort after the declaration of insolvency and until its conclusion;
6. 50 per cent of the funds lent under a refinancing arrangement entered into in compliance with the requirements set forth in Article 614 et seq (restructuring plans) of the Spanish Insolvency Act;[30] and
7. certain debts incurred by the debtor following the declaration of insolvency.

Insolvency claims

Insolvency claims are subject to the insolvency proceedings and, unlike the claims against the insolvency estate, are paid in accordance with the waterfall set forth in the Spanish Insolvency Act. In principle, the insolvency waterfall applies mandatorily; that said, the waterfall may be altered among the creditors that are party to a contractual subordination agreement to the extent the debtor is party to such agreement and it does not cause any prejudice to any third parties.

Insolvency claims, in turn, are classified as follows:

1. special privilege claims, referring to claims that benefit from security interest on certain assets (essentially *in rem* security, to the extent secured by *in rem* security);-[31]
2. general privilege claims, referring to, among others, certain labour debts and debts with public administrations corresponding to tax debts and social security obligations (recognised as generally privileged for half of their amount), and debts held by the creditor applying for the corresponding insolvency proceedings (to the extent such application has been approved) up to 50 per cent of the amount of such debt. Up to 50 per cent of the amount of either any interim financing[32] or new financing[33] provided within the framework of a homologated restructuring plan also benefits from general privileges, to the extent that the claims affected by the relevant plan represent at least 51 per cent of the total liabilities of the insolvent debtor. In the same line, if the interim financing or new financing is provided by parties who are specially related to the debtor, 50 per cent of the amount of such financings will also benefit from general privileges to the extent that the claims affected by the relevant restructuring plan represent at least 60 per cent of the total liabilities of the insolvent

debtor (deducting the claims held by any specially related person to the insolvent debtor to calculate the aforementioned majority);

3. ordinary claims (unsubordinated and non-privileged claims); and
4. subordinated claims; debts subordinated by virtue of law include, among others, claims that have been notified late by the creditors (other than claims of mandatory recognition), fines, profit participation loans, claims related to accrued and unpaid interest unless and to the extent they are secured by an *in rem* right, as well as, in particular, credit rights held by parties that are specially related to the debtor (discussed further in Section IV.ii).

Subordination

Credit rights may be subordinated by virtue of law, by contractual agreement or as a result of the structure of the debt. Contractual subordination must be accepted by all of the creditors whose claims are affected by the relevant subordination.

Contractual subordination agreements are now recognised within insolvency proceedings provided that the insolvent debtor is party to those agreements and they do not cause prejudice to any third parties. Contractual subordination agreements are binding to the insolvency administrators, who will make the payments in accordance with the relevant rules or waterfalls set out in the agreements. Contrary to what happens in an insolvency scenario, contractual subordination agreements have not been expressly recognised for the purposes of class formation to vote the approval of a restructuring plan.

Pursuant to the Spanish Insolvency Act, credit rights held by parties that are specially related to the debtor are subordinated. In the case of individuals, this includes their relatives. In the case of legal entities, this includes:

1. shareholders, group companies and their common shareholders, provided that:
    - they are personally liable for the debtor's debts;
    - they owned directly or indirectly over 5 per cent (for companies that have issued securities listed on an official secondary market) of the entity's share capital when the relevant debt was incurred; or
    - they owned directly or indirectly over 10 per cent (for companies that have not issued securities listed on an official secondary market) of the entity's share capital when the relevant debt was incurred; and
2. directors and de facto (shadow) directors, liquidators and attorneys holding general powers of attorney, as well as those who held such positions within the two years immediately preceding the initiation of insolvency proceedings.

In addition to the above, there is a presumption that any persons who have acquired credit rights from the specially related persons described above within the two years immediately preceding the initiation of insolvency proceedings are also specially related to the debtor. Therefore, their claims will become subordinated.

Notwithstanding the above, it is noteworthy that creditors who have capitalised all or part of their claims pursuant to a homologated restructuring plan in accordance with Article 635 et seq of the Spanish Insolvency Act are not deemed specially related persons as a result of said restructuring, and any creditors who are party to an homologated restructuring plan are deemed not to be de facto directors because of the obligations assumed by the debtor pursuant to the restructuring plan (although evidence to the contrary may be admitted).

Jurisdiction

Choosing the laws of any jurisdiction other than Spain will generally be given effect by the Spanish courts subject to, among other things, the terms of the Rome I Regulation[34] and in accordance with the exceptions and provisions of the laws of Spain, provided that the relevant applicable law is evidenced to the Spanish courts pursuant to Article 281 of the Spanish Civil Procedure Act,[35] and pursuant to Article 33 of the Act on International Legal Cooperation in Civil Matters.[36]

Furthermore, a final judgment obtained against any debtor or guarantor in a country other than Spain that is not bound by the provisions of Regulation (EU) No. 1215/2012[37] and is not party to an international treaty providing for the recognition and enforcement of judgments between Spain and the countries where the judgments were rendered would be recognised and enforced by the courts of Spain in accordance with and subject to Article 523 of the Spanish Civil Procedure Act and subject to the Act on International Legal Cooperation in Civil Matters.[38]

The party seeking enforcement should initiate the recognition proceedings in Spain before the relevant court of first instance or commercial court, as the case may be. According to Article 46 of the Act on International Legal Cooperation in Civil Matters, 'a final foreign judgment would not be recognised:

> (a) if the judgment contravenes Spanish public policy rules (orden público);
> (b) if the judgment was rendered infringing the rights of defence of either party. If the judgment was rendered by default, it would be understood that the rights of defence have been clearly infringed provided that the defendant was not served with the document that instituted the proceedings in a timely manner that allowed for adequate defence;
> (c) if the judgment addresses a matter over which Spanish courts have exclusive jurisdiction or, in relation to other matters, if the jurisdiction from the court of origin over the matter is not clearly connected to said country of origin in which the judgment was rendered;
> (d) if the judgment is irreconcilable with a judgment rendered in Spain;
> (e) if the judgment is irreconcilable with an earlier judgment rendered in any other State provided that such judgment complies with the applicable conditions to be recognised in Spain;
> (f) if there is judicial proceeding outstanding in Spain between the same parties and in relation to the same issues in Spain, instituted before the foreign proceeding.

The Act on International Legal Cooperation in Civil Matters expressly prohibits that a foreign judgment is reviewed as to its substance by the Spanish competent court.

Finally, any judgment obtained against a debtor or guarantor in any country bound by the provisions of Regulation (EU) No. 1215/2012 would be recognised and enforced in Spain in accordance with the terms set forth therein.

Acquisitions of public companies

Loans financing tender offers are not that different from non-public acquisition finance deals, although lenders need to focus on the bank guarantees that the Spanish National Securities Market Commission (CNMV) requires as evidence that the relevant acquirer will be able to comply with its obligations under the public offer to purchase, to make sure that these are adequately integrated in the financial documents and to consider the unconditional nature of these guarantees at the time issued. That said, there are a series of specific provisions that are normally included in this kind of financing, such as:

1. undertakings related to the offer that could prevent the bidder from amending certain terms or conditions to which voluntary offers may be subject to;
2. a mechanism regulating the replacement of the aforementioned guarantees if additional lenders join the original guarantee providers once the aforementioned guarantees have been deposited with the CNMV;
3. a 'deemed-utilisation' mechanism by means of which the enforcement of the guarantees by the CNMV would constitute an automatic drawdown under the financing for the relevant claim amount; and
4. the obligation of the bidder to pledge the target shares in favour of the lenders once the offer is settled.

The offer prospectus must give details about how the tender offer is going to be financed, and therefore certain details of the relevant debt instruments will need to be made public.

Spanish stock corporations are governed by the Spanish Securities Market Act[39] and Royal Decree 217/2008 of 15 February on the legal regime applicable to investment services companies. The Spanish authority responsible for approving any takeover bid launched is the CNMV.

When someone directly or indirectly acquires control over a publicly listed company (i.e., has at least 30 per cent of the voting rights), a tender offer for all outstanding shares in that company is mandatory. The mandatory takeover bid will also be triggered when someone does not hold more than 30 per cent of the voting rights but has appointed, within 24 months following the acquisition, a number of directors that together with those already appointed by the bidder, if any, represents more than half of the members of the board of directors.

The aforementioned threshold can be obtained:

1. by means of an acquisition of shares or other securities that confer, directly or indirectly, voting rights in the company;
2. through shareholders' agreements; or
3. as a result of indirect or unexpected takeovers.

Without prejudice to the above, the Spanish Securities Market Act provides for certain exceptions for the launching of a mandatory offer upon gaining control of a listed company; for instance, creditors acquiring the control of a listed company as a result

of the capitalisation of their debt within the context of a homologated restructuring plan that is favourably informed by an independent expert will not be obliged to launch a mandatory tender offer without the necessity of getting an exemption from the Spanish Stock Exchange Commission.

Mandatory takeover bids must be made at an 'equitable price'; that is, an equal price to the highest price that the party required to launch a takeover bid (or those persons acting in concert with it) has paid for the same securities during the 12 months prior to the announcement of the bid. Contrary to this, in a voluntary takeover bid, the bidder is free to offer whatever price it wishes.

Outlook and conclusions

The worldwide macro-environment will suffer from high uncertainty and direct lending will keep filling the supply gap left by the less risk-tolerant and heavily regulated banking sector. Practitioners expect that direct lenders who have large dry powder cash piles to deploy will win traditional lenders' market share year after year, and that the slowdown in mega-market deals will open the door for mid-market financing to dominate.

Amend-to-extend transactions are highly expected in the upcoming year; however, amend-to-extend transactions may not be an option for those sponsors and borrowers who do not have a realistic prospectus of returning to growth in the medium and long term. As a consequence, the new Spanish Insolvency Act, in particular the heavily updated pre-insolvency institutions, are expected to play a major role in helping debtors and creditors to restructure debt following much more flexible rules. It is still unknown if the Spanish mercantile courts will be able to accommodate this new weapon and to become allies of the market players to achieve this goal.

We also expect the top-tier Spanish acquisition finance market to continue its process of incorporating the latest front-running US and London leveraged finance structures and trends.

Endnotes

1 Fernando Colomina, Ivan Rabanillo and José María Alonso are partners, Luis Sánchez is a counsel and Pablo Alarcón is an associate at Latham & Watkins. ^ Back to section

2 In the fiscal year beginning in 2023, there is a temporary limitation to the offset of tax losses incurred by a group member entity for purposes of the tax group's consolidated CIT. In 2023, only 50 per cent of stand-alone tax losses may be offset. From 2024 (and unless this limitation rule is extended), the pre-2023 regime should be reinstated, and there should be no limitation to the offset of current-year tax losses within a tax group. ^ Back to section

3 Sponsored by the OECD and sanctioned by the G20. ^ Back to section

4 Regulated financial institutions and insurance companies (and their holding companies, to the extent they are subject to the oversight of the financial or insurance regulators) may not be subject to the interest-stripping rules and the anti-LBO rule (described below). ^ Back to section

5 The Spanish tax authorities, in binding tax ruling V1664-15, dated 28 May 2015, have addressed certain queries made by a private equity firms association regarding the practical applicability of the anti-LBO rule. According to the tax authorities, the fulfilment of the second requirement should be tested on an annual basis, by comparing the level of indebtedness of the bidco at the end of each fiscal year with the acquisition debt. Even if the acquisition debt accounted for less than 70 per cent of the purchase price, its principal amount should be nevertheless reduced proportionally on annual basis over an eight-year period until it reaches 30 per cent. Nonetheless, if in a given year the acquisition debt is reduced at an amount exceeding the minimum amount required to be amortised as per the amortisation schedule of the anti-LBO rule, the taxpayer may not be required to reduce it further in subsequent years until the remainder of the debt catches up with the amortisation schedule. ^ Back to section

6 See binding tax ruling V1664-15. The failure to meet the mandatory amortisation requirements in a given fiscal year does not jeopardise the taxpayer's ability to deduct interest on the debt in future fiscal years, provided that the taxpayer catches up with the amortisation schedule in the subsequent years. ^ Back to section

7 In the context of LBOs, it may be possible to refinance existing acquisition debt deemed to be 'tainted' by operation of the anti-LBO rules without running afoul of the anti-LBO rules, although this possibility should be analysed on a case-by-case basis and bearing in mind the legal ramifications of refinancing. In binding tax ruling V4487-16, dated 18 October 2016, the Spanish tax authorities concluded that the swapping of tainted acquisition debt by refinancing debt used to finance a 'dividend recap' distribution to shareholders might, in some circumstances, not be tainted for purposes of anti-LBO rules. ^ Back to section

8 In that regard, there are good grounds to defend (as per the criterion set forth by the Spanish tax authorities in certain binding tax rulings – such as V0775-15, dated 10 March 2015) that there are 'sound business reasons' where the leveraged intra-group acquisition is performed in a connection with a post-acquisition debt push-down plan (e.g., following the acquisition of a multinational group, partly financed with bank debt, the purchaser group sets up a structure that would allow a portion of such acquisition debt to be allocated to Spain), provided that the portion of the debt pushed down to Spain is reasonable. In any event, it is generally advisable that a taxpayer seeks a binding tax ruling from the Spanish tax authorities to implement a restructuring plan. ^ Back to section

9 The Spanish CIT Act provides for an anti-hybrid rule transposing the contents of the ATAD 2 Directive (Council Directive (EU) 2017/952, dated 29 May 2017, amending Council Directive (EU) 2016/1164 as regards hybrid mismatches with third countries). In a nutshell, the ATAD 2 regime aims at, among others, avoiding situations where deductions may be claimed by a Spanish CIT taxpayer and by another person in a different jurisdiction (a double deduction outcome) or where deduction does not lead to the inclusion of matching income in another jurisdiction, as a consequence of a conflict in the characterisation of financial instruments, payments or entities. The scope of ATAD 2 is generally limited to related-party transactions, although such measures may apply in respect of third-party arrangements that are deemed to be 'structured arrangements' (i.e., an arrangement where the tax mismatch is priced into its terms or that was designed to produce such an outcome). These rules apply in respect of all tax years ending after 11 March 2021. ^ Back to section

10 Several Supreme Court decisions ruled in favour of taxpayers in cases where the tax audit challenged the deductibility of interest accruing in connection with loans taken to finance distributions to shareholders, on the grounds that the interest was incurred for the benefit of the recipient shareholder and was unrelated to the business activity of the borrower. The courts rejected this view. Nonetheless, an anti-abuse report issued by the Spanish tax authorities in July 2022, addressing a structure where loan financing funded a share premium repayment following an intra-group reorganisation, suggests that the tax authorities may scrutinise certain leveraged distributions on anti-abuse grounds, through the application of general anti-abuse rules. ^ Back to section

11 Except for EU- and EEA-based lenders resident in or obtaining interest through a permanent establishment located in Spain or in a non-cooperative (i.e. tax-haven) jurisdiction. Currently, no EU or EEA Member States are blacklisted from a Spanish tax perspective, but the Spanish tax authorities may revisit the blacklist depending on certain factors (e.g., where there is no effective exchange of tax information, or where the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes identifies a jurisdiction as a tax haven). ^ Back to section

12 Act 10/2014, dated 26 June, on the organisation, supervision and solvency of credit entities. ^ Back to section

13 Notes offerings carried out by non-Spanish issuer vehicles, where the offering proceeds are ultimately used in Spain, should be carefully reviewed in light of the criterion set forth in binding tax ruling V4139-15, dated 28 December 2015, where the Spanish tax authorities took the view that interest accrued under these notes could be deemed to be from Spanish sources for Spanish WHT purposes. In such cases, it would be crucial to ensure that the offering meets the criteria to be a qualifying note offering from a Spanish tax perspective, and that the applicable compliance obligations are duly met by the paying agent involved. ^ Back to section

14 According to the CIT Act, a Spanish parent company (or permanent establishment) holding a direct or indirect participation in a Spanish subsidiary through intermediate holding companies resident in any country other than Spain could form a tax group including indirect Spanish subsidiaries, provided that the indirect shareholding of the Spanish parent company represents at least 75 per cent of the share capital of the Spanish subsidiary (70 per cent if the subsidiary has its stock listed in a regulated stock exchange) and the majority of the subsidiary's voting rights. Parent companies resident in a tax-haven jurisdiction or not subject to a corporate-level tax are not eligible to be an ultimate parent company for purposes of the tax group regime. ^ Back to section

15 Temporary Provision 25, Subsection 2. This provision has been interpreted by the Spanish tax authorities in binding tax ruling V2037-15, dated 30 June 2015. The case described in the mentioned ruling was the case of two Spanish consolidated tax groups that had a common parent company resident in Luxembourg. According to the Spanish tax authorities, from the fiscal year 2015 both groups should be combined into a single tax group (as the qualifying parent company of both groups was the same Luxembourg entity). ^ Back to section

16 See binding tax ruling V2037-15. This means the taxpayer may choose to terminate the pre-existing group that could trigger fewer de-grouping costs. ^ Back to section

17 Several Spanish CIT rules ask for the fulfilment of requirements at the tax group level (for instance, the rules limiting the deductibility of interest), and the enlargement of a tax group may lead to unexpected tax inefficiencies (and to a greater tax compliance burden). ^ Back to section

18 Entities belonging to a tax group are jointly and severally liable for the CIT debts of the group. In addition, the inclusion of entities in a tax group means that these entities may have accounts payable and receivable as regards other group entities, depending on whether an entity benefits from tax credits or attributes of another entity of the tax group. This aspect may also be troublesome from the perspective of the financial institutions involved. ^ Back to section

19 For instance, the Spanish tax authorities have interpreted that certain investment structures with features designed to ensure that a 'master' holding company could not meet the requirements set out under the Spanish CIT Act to be regarded as a parent entity that could have the status of a head of a consolidated tax group (see, e.g., binding tax rulings V1813-16, dated 25 April 2016, and V1083-16, dated 17 March 2016). However, the use of these structures should be approached with caution and on a case-by-case basis. ^ Back to section

20 In addition, the performance of a post-LBO forward merger requires analysis from a Spanish tax perspective, as it is key that the merger can be performed in a tax-neutral fashion (which requires, among other things, that the reorganisation is deemed to have been performed because of sound business reasons and not for tax-driven ones). These mergers have been contested by the Spanish tax authorities in the past (especially in structures where the merger could give rise to certain tax advantages, and given the potential implications of a busted reorganisation – that is, taxation at the merged company level in respect of the assets transferred to the merging entity – these transactions should be approached with caution). On the other hand, the performance of a post-LBO reverse merger may pose fewer tax issues and may entail certain advantages from a non-tax perspective, as these mergers may provide for a book-up of the balance of distributable reserves of the target company (from an accounting and corporate law perspective). Additional reserves may provide for an additional buffer for distributions that – if the acquisition debt is placed at the level of a holding company – may facilitate the servicing of acquisition debt. ^ Back to section

21 Royal Legislative Decree 1/2020 of 5 May 2020, as amended by, among others, Law 26/2022 of 5 September (by means of which the Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt was transposed into Spain. Law 26/2002, by virtue of which the restated Spanish Insolvency Act was approved to organise, harmonise and clarify the insolvency law, which had suffered numerous root-and-branch amendments. It does not include substantial amendments although, as mentioned above, the legislator has taken advantage of the recast to clarify certain provisions that could lead to false interpretations. ^ Back to section

22 The share capital of an SL is represented by 'quotas', whereas the share capital of SAs is represented by 'shares'. This distinction is especially important in the application of RDL 5/2005 (see below). ^ Back to section

23 Act 2/1981 of 25 March, on the regulation of the mortgage market. ^ Back to section

24 Article 153*bis* of Spanish Mortgage Law dated 8 February 1946. ^ Back to section

25 Royal Decree Law 5/2005 of 11 March on urgent reforms for boosting productivity and to improve public procurement. ^ Back to section

26 Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements. ^ Back to section

27 Quotas in an SL do not qualify for these purposes. ^ Back to section

28 Judgment dated 10 November 2016 in the Matter No C-156/15 (*Private Equity Insurance Group (SIA) v. Swedbank AS*) in response to a request for a preliminary ruling from the Supreme Court of Latvia. ^ Back to section

29 See Section III.ii. ^ Back to section

30 From 2 October 2016, 50 per cent of the new funds under a formal refinancing are regarded as a claim against the insolvency estate and the remaining 50 per cent as a generally privileged claim. ^ Back to section

31 For the purposes of a composition or a restructuring plan, the special privilege will be limited only to the reasonable or fair value of the charged asset. The amount in excess of such reasonable or fair value will not be considered as a special privilege claim. This limitation does not apply to the right of the secured creditor to recover the amount secured or guaranteed by the relevant security interest or guarantee, as applicable. ^ Back to section

32 Interim financing is referred to in the Spanish Insolvency Act as any financing provided to the debtor while the debtor is negotiating a restructuring plan with its creditors, to the extent such financing is reasonably needed to ensure the continuity of the debtor's business or professional activity during negotiations or preserve or improve the value that the business, as a whole, or of one or several productive units, had at the time of the commencement of negotiations. ^ Back to section

33 New financing is referred to in the Spanish Insolvency Act as financing that is foreseen in the restructuring plan and is necessary for its fulfilment. ^ Back to section

34 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). ^ Back to section

35 Act 1/2000 of 7 January on Civil Procedure. ^ Back to section

36 Act 29/2015 of 30 July on International Legal Cooperation in Civil Matters. ^ Back to section

37 Regulation (EU) No. 1215/2012 of the European Parliament and of the Council on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters. ^ Back to section

38 The Act on International Legal Cooperation in Civil Matters repealed Articles 951–958 of the former Spanish law civil procedural of 1881. ^ Back to section

39 Law 6/2023 of 17 March on securities markets and investment services. ^ Back to section

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Overview

i The covid-19 pandemic

In Switzerland, as in many other jurisdictions, financial markets struggled in 2020 as a result of the covid-19 pandemic. In March 2020, the Swiss Federal Council (Bundesrat) declared the 'extraordinary situation' and introduced stringent measures, including the lockdown of schools, shops, restaurants, bars and entertainment and leisure facilities.

The Swiss Federal Council and the Swiss government passed various regulations in response to the covid-19 pandemic, including the set-up of the Swiss Covid-19 Loan Programme under an emergency ordinance (the Covid-19 Ordinance on Joint and Several Guarantees). Covid-19 loans with an aggregate volume of over 17 billion Swiss francs were granted under the programme. Covid-19 loans with an aggregate volume of approximately 6 billion Swiss francs were repaid by September 2022 and loans amounting to roughly 500 million Swiss francs have been honoured by the guarantee provided by the Swiss authorities. Hence, a significant number of covid-19 loans are still outstanding. While no further covid-19 loans were granted after July 2020, a number of important restrictions apply to companies that continue to be financed by covid-19 loans. This is because the purpose of such loans is, in short, limited to ensuring continuity of the business. While the restrictions under the Swiss Federal Act on Covid-19 Credits with Joint and Several Guarantee are more relaxed than under the original emergency ordinance, certain key restrictions still apply. Hence, a borrower of a covid-19 loan must not:

1. pay dividends or bonuses to shareholders or repay equity capital to shareholders;
2. grant loans or repay loans or other obligations to affiliated parties, unless such loan or other obligation was pre-existing;
3. refinance intragroup loans, except for pre-existing obligations for the payment of interest and amortisations; or
4. on-lend, or make otherwise available the proceeds of covid-19 loans to group companies outside Switzerland, except for pre-existing obligations for the payment of interest and amortisations.

These restrictions are problematic for operating entities that form part of a larger group of companies, where the group relies on cash flows generated by these operating entities. Debt servicing on the top level of a group becomes difficult where the operating entities are restricted to upstream cash flows. Also, there remains uncertainty over whether the sole granting of a guarantee, or the granting of security to guarantee or secure liabilities of a shareholder, could be considered as paying dividends. If so, such a security or guarantee might be affected as to its validity by the provisions of the Swiss Federal Act on Covid-19 Credits with a Joint and Several Guarantee.

These restrictions affect the structuring of financing transactions and, accordingly, borrowers are incentivised to repay covid-19 loans sooner rather than later to rid themselves of such restrictions. Also, where group financing transactions have had to be renegotiated and covenant or even payment holidays have been granted by the lenders,

the lenders have normally insisted on a clear road map towards early repayment of the covid-19 loans.

ii LIBOR cessation

Status

The London Interbank Offered Rate (LIBOR) for Swiss francs and other currencies was phased out on 31 December 2021 and has been replaced by alternative benchmarks in the form of risk-free rates. In Switzerland, the most comment risk-free rate used in the lending market is the Swiss Average Rate Overnight (SARON).

Hence, throughout the past year, banks have been intensively working on the transition of their loan portfolios from LIBOR to SARON and on updating the respective legal documentation. It seems that the Swiss lending market has adapted to this change quite well, and it appears that the transition process has been relatively smooth in most instances.

However, while the transition process is complete for some currencies (including Swiss francs), the process is ongoing, as other currencies (including the US dollar) are still to be phased out and replaced by alternative benchmarks. Most importantly for the Swiss market, EURIBOR continues to be used as a euro-based rate for now, but upcoming developments need to be closely monitored.

Calculation methodology used in the Swiss market

In Switzerland, during the initial phase of the transition, the calculation methodology 'cumulative compounded SARON' has been frequently used as an alternative benchmark for the new compounded SARON as recommended by the Swiss National Working Group on Swiss Franc Reference Rates. The legal documentation has been updated accordingly. This calculation methodology differs from the methodology applied by the Loan Market Association (LMA) as reflected in the LMA-recommended form rate switch documentation (i.e., daily non-cumulative compounded rate). It turned out that non-Swiss banks and lenders were not very familiar with the Swiss approach. As a consequence, during a later phase of the transition process and in situations where there are non-Swiss financial institutions in the syndicate of lenders, the LMA calculation methodology has typically been introduced in the legal documentation. Also, in multicurrency facilities agreements, in order to avoid different methodologies being implemented in relation to the different facilities, the daily non-cumulative compounded rate is used for calculating interest on a daily basis.

Running two different regimes in the same market is not very efficient and it seems that the market in Switzerland is now shifting away from the 'Swiss solution' to the more common international standard suggested by the LMA. Even in new lending transactions that are purely domestic, the calculation methodology used is now most often the daily non-cumulative compounded rate.

Break costs

In transactions where LIBOR applies or applied, the borrower was under an obligation to pay break costs to the lenders upon prepayment of a loan during an interest period. The break cost concept assumes that each lender matches the funding of its loans to the actual term of the respective interest period of a loan and potentially suffers a loss if the interest that a lender should have received for the remainder of the interest period exceeds the actual amount that a lender would be able to obtain by redepositing the money for the period from prepayment of the loan until the last day of the interest period.

This rationale does not apply where a loan references risk-free rates, as risk-free rates accrue on a daily basis and are not an approximation of the cost to the bank of maintaining the loan over the interest period. Nevertheless, the agent and lenders may incur a loss if their funding arrangements for maintaining a loan are interrupted by a prepayment and for any administrative burdens. There are different ways to address this. A prepayment could trigger a one-time fee per prepayment or a portion of the margin could still be due for the remainder of the interest period. Alternatively, the number of voluntary prepayments could be limited during a year for purposes of avoiding revolving facilities being used almost as overdraft facilities. It now seems that a standard has evolved for the Swiss market, which is a combination of a limitation of the prepayments allowed and a one-time fee to be paid by the borrower upon prepayment, but it should be noted that there are still various options to play around with these elements.

iii Sanctions

Following the invasion of Ukraine by Russian military forces, the Swiss Federal Council enacted the ordinance on measures relating to the situation in the Ukraine on 4 March 2022 based on the powers assigned to it by the Swiss Federal Constitution and the Swiss Federal Embargo Act. Since 4 March 2022, the ordinance has been constantly revised and expanded.

Generally, the Swiss sanctions regime follows the sanctions regime enacted by the European Union. However, there are some deviations, in particular as regards the list of sanctioned persons. In addition, the Swiss State Secretariat for Economic Affairs (SECO), which is in charge of implementing the ordinance, has published certain FAQs thereby providing further guidance to the market.

The ordinance is applicable to all people and companies within Switzerland, but, other than the EU and the US sanctions rules, is not addressed to Swiss citizens living outside Switzerland.

Like the EU sanctions regime, the ordinance addresses and covers the following elements:

1. commercial restrictions, preventing the sale of certain goods to Russia (e.g., weapons, dual-use goods, certain technology goods, goods related to the aerospace sector and the shipping sector (including the rendering of services), goods related to the oil and energy production sector, energy, luxury goods and gold);
2. a general asset freeze of assets held by sanctioned persons;
3. reporting obligations in relation to such assets held by sanctioned persons;
4. a ban on taking deposits from Russian citizens and certain institutions;

5. a ban on the rendering of financial, financing, trading and investment services to – and the financing of – certain counterparties;
6. travel bans for sanctioned persons and a general ban on air traffic for aircraft registered in Russia;
7. limitations on dealing with certain counterparties, such as the Russian Central Bank and other government authorities;
8. a ban on honouring and paying certain claims if they arise under an agreement that is otherwise limited by the Swiss sanction rules;
9. a ban on establishing trusts if the beneficial owners are specific persons or entities; and
10. a ban on rendering services in the areas of tax, accounting, auditing and certain other services to entities located in Russia.

Along with the sanction regimes of other countries, the Swiss regime will continue to evolve and expand. Also, the interpretation of the sanctions rules will continue to be highly dynamic. Hence close monitoring is key, in particular as the time periods in which such updates enter into force are normally extremely short.

iv ESG (environmental, social and governance)

The number of ESG-linked credit financing transactions is constantly increasing in the Swiss lending market. However, compared with the Swiss bond market, where a considerable number of sustainability-linked bonds, sustainable bonds, a large number of green bonds and even social bonds have been issued and listed on the SIX Swiss Exchange, the number of ESG-linked credit financing transactions is still relatively low and mostly limited to corporate credit financing transactions. Also, it seems that in private equity-sponsored Swiss leveraged finance transactions (that are mainly mid- or small-cap transactions), ESG is not (yet) a hot topic. It is, however, clear that the topic has more and more a high priority on the banks' agendas,

Typically, Swiss ESG-linked credit financing transactions do not provide for a 'use of proceeds' concept where the funds raised shall exclusively finance specific green, sustainable or social business transactions or assets. This provides the borrower with some flexibility, which is still important in revolving credit financing transactions where funds raised can be used for any corporate purposes. Rather, certain key performance indicators (KPIs) are defined in the documentation. The basis for such KPIs differs from industry to industry. Typically, there is no hard requirement to meet certain KPIs. Rather, the borrowers benefit from a reduction of the margin if the KPIs are met or even exceeded and are punished by an increase of the margin if the KPIs are not met. A challenging element of the ESG-linked transactions continues to be the monitoring, reporting and auditing of compliance with ESG criteria.

Clearly, the market for ESG-linked credit financings is rapidly growing and is becoming more and more sophisticated also in Switzerland.

Regulatory and tax matters

i Regulatory matters

The mere provision of acquisition finance does not itself trigger a licensing requirement under Swiss laws. A licensing requirement would only be triggered if lenders would refinance themselves in Switzerland by means of accepting money from the public or via a number of unrelated banks. Lending into Switzerland on a strict cross-border basis is currently not subject to licensing and supervision by the Swiss Financial Market Supervisory Authority, FINMA.

Under the Swiss Financial Services Act (FinSA), financial advisers are required to register and accordingly, financial advisers of foreign financial institutions may only be active in the Swiss market once they are registered in the register of financial advisers. However, a person advising exclusively in the context of finance (lending) transaction will be out of scope of the registration requirement.

ii Tax matters

10/20 non-bank rules – political developments and the public vote of September 2022

Under the current Swiss withholding tax regime, 35 per cent Swiss Federal withholding tax is levied on interest paid to Swiss or foreign investors on bonds and similar collective debt. Any financing (including credit financings) may be subject to such a treatment in the event that the number of non-bank creditors under such a financing exceeds 10.

On 3 April 2020, the Swiss Federal Council initiated a consultation process (-*Vernehmlassung*) regarding a planned reform of the Swiss federal withholding tax. The reform originally intended to replace the current debtor-based regime applicable to interest payments with a paying agent-based regime for Swiss federal withholding tax. As a consequence of the consultation process, the Swiss Federal Council, on 11 September 2020, decided to abolish Swiss withholding tax on interest payments (with the exception of interest payments on domestic bank accounts and deposits to Swiss resident individuals) without substitution and it submitted a corresponding legislative project to Parliament on 14 April 2021.

The abolition of Swiss withholding tax on bonds and other collective debt financings aimed to strengthen Switzerland's position as a financial market and treasury centre. All types of financing and refinancing activities in Switzerland (e.g., raising capital via bond issuances, crowdfunding platforms, ABS structures and other capital market transactions) would have been facilitated.

A referendum was initiated against such a legislative project (and the abolition of the Swiss withholding tax on interest payments) and the project therefore brought to a public vote by the people of Switzerland. On 25 September 2022, the Swiss people declined the new legislative project with 52 per cent of voters being against the reform.

Accordingly, the Swiss withholding tax regime remains unchanged and it is worth summarising the current regime again.

10/20 non-bank rules – Swiss withholding tax

Unlike most other countries, under the current Swiss withholding tax regime, Switzerland does not levy withholding tax on interest paid on private and commercial loans (including on arm's-length inter-company loans). Rather, 35 per cent Swiss federal withholding tax is levied on interest paid to Swiss or foreign investors on bonds and similar collective debt instruments issued by or on behalf of Swiss resident issuers. According to the Swiss Federal Tax Administration and the relevant regulations, credit facilities also qualify as collective debt instruments, if syndicated outside of the banking market and, as a result, there are more than 10 non-bank lenders in the syndicate.

International capital markets do not typically respond well to bonds subject to Swiss withholding tax. Therefore, the investor base is relatively often limited to Swiss investors, or, in the case of Swiss multinational groups, bonds are issued through a foreign subsidiary. However, the Swiss Federal Tax Administration reclassifies such foreign bonds into domestic bonds if the amount of proceeds used in Switzerland exceeds certain thresholds (i.e., the combined accounting equity of all non-Swiss subsidiaries of the Swiss parent company and the aggregate amount of loans granted by the Swiss parent and its Swiss subsidiaries to non-Swiss affiliates).

In the context of syndicated credit financing transactions, it must be ensured that no Swiss federal withholding tax will be incurred, as this would simply not be acceptable to lenders, even in case the Swiss federal withholding tax could be recovered at some later point. In order to prevent Swiss federal withholding tax from being imposed on credit financing transactions (in contrast to bonds triggering such tax anyway), credit facility agreements entered into by a Swiss borrower, or a non-Swiss borrower under a guarantee from a Swiss parent company, must contractually restrict free transferability and syndication by invoking the '10/20 non-bank rules' and stating that (1) the lenders must ensure that while the loan in question is outstanding, no assignments, transfers or relevant sub-participations of loan tranches will be made, as a result of which the number of ten non-bank lenders would be exceeded and (2) the borrower must ensure that it will at no time have more than 20 non-bank lenders under any of its borrowings (in both cases generally disregarding any affiliated lenders).

As a result, credit financing transactions that must be broadly syndicated outside the banking market, because the banking market would not absorb such transaction, (such as TLB transactions) cannot provide for a Swiss borrower and it is necessary to structure around this.

In addition, the Swiss Federal Tax Administration may reclassify a syndicated credit financing transaction raised by a non-Swiss affiliate in the event that (1) the proceeds are (directly or indirectly) used in Switzerland and (2) a Swiss group entity provides security or a guarantee to secure such a credit financing. In the event that the security or guarantee provided by the Swiss group entity is only of an upstream or cross-stream nature, this doctrine of the Swiss Federal Tax Administration does not normally apply, but this must be confirmed by the Swiss Federal Tax Administration by way of a tax ruling confirmation on a case-by-case basis. Acquisition bonds issued for Swiss acquisitions will thus be issued abroad on a higher-tier level and on-lent through the acquisition structure down to the Swiss buying entities.

Deductibility of interest expense

Under Swiss tax law, interest incurred at the level of the acquisition vehicle is not available for set-off against income generated at the Swiss target company level for income tax purposes. This is because there is generally no tax consolidation under Swiss tax law (neither in Swiss domestic nor cross-border situations). However, there are means to (indirectly) 'push down' the acquisition debt portion, particularly if the existing debt can be refinanced at the target level. For the purposes of the Swiss Non-Bank Rules, this would need to be structured as a downstream loan from the acquisition vehicle to the target level (or by refinancing the existing debt at the target level, although that would result in a limitation of the number of non-banks to 10 for that portion of the debt in any event). However, since the proceeds of the acquisition debt may be lent on, the Swiss Non-Bank Rules have to be carefully addressed.

Alternatively, an (indirect) pushdown can be achieved by way of an equity-to-debt swap, where equity (freely distributable reserves or even share capital that can be reduced) is distributed (but not actually paid out) and converted into a downstream loan. In recent transactions, additional pushdown of debt potential has been created by some post-acquisition restructuring steps (such as group internal sales of assets generating additional earnings and the respective debt capacity).

If such a pushdown can be achieved, some of the interest incurred on the acquisition debt may be brought to the target company level and become available for set-off against income generated at the target level. The security package structure may be improved in connection with such pushdown at the same time.

Security and guarantees

i Standard security package at closing

In leveraged acquisition finance transactions involving Swiss target companies, the acquisition debt portion usually benefits from the share pledge over the Swiss target company. In most cases, the security package is completed by other security provided by the acquisition vehicle, such as security over:

1. claims and rights under the share purchase agreement;
2. claims and rights under due diligence reports;
3. claims and rights under intragroup loans;
4. claims and rights under insurances (in particular, M&A insurances, if any); and
5. bank accounts.

Share pledge

Under Swiss law, shares in stock corporations and limited liability companies may be pledged by written agreement and if share certificates have been issued by handing over

the certificate to the pledgee (duly endorsed or assigned (as applicable) in blank in the case of registered shares). If certificates have been issued, the handover of such certificates is a perfection requirement for the pledge. While a pledge over shares can be perfected, even if no certificates have been issued, the issuance and handover of certificates it is generally considered to bring the pledgees into a factually stronger position in the event of enforcement. In addition, it is standard that any transfer restrictions in the target company's articles of association are removed. Provisions in the articles of association limiting the representation of shareholders at shareholders' meetings to other shareholders must also be lifted to ensure full flexibility once control over the shares has been gained. Given the lack of control over the target company pre-closing, the issuance of certificates and the amendment of the articles of association are generally accepted as (immediate) conditions subsequent.

Claims and receivables

Claims and receivables (claims under the share purchase agreement, insurance claims, claims under due diligence reports, etc.) may be assigned under Swiss law for security purposes by means of a written agreement between assignor and assignee. The agreement must specify the relevant claims and may cover future claims as well, provided claims are described in a manner that allows for clear identification once such claims come into existence. However, it must be noted that claims arising post-bankruptcy with a Swiss assignor would no longer be validly assigned and would be trapped in the bankrupt estate.

While assignability is generally given under Swiss law if the underlying agreement is tacit as regards or explicitly allows for an assignment, it is important that the underlying agreement does not contain a ban on assignment. Therefore, during the pre-signing phase, the parties must ensure that all relevant documents do not contain any restrictions on assignment (particularly the share purchase agreement, insurances, etc.) and, for the sake of clarity, it is even recommended that important agreements explicitly allow for an assignment for security purposes to financing parties. The same applies to any due diligence reports, although getting the benefit through reliance will also be satisfactory in most circumstances (either directly derived from the report or through additional reliance letters).

Although the requirement to notify third-party debtors (such as the sellers) is not a perfection requirement under Swiss law, it is recommended that these parties are notified of the assignment for security purposes and the transaction as a whole, even though, prior to an enforcement event, the security provider continues to be free to deal with these claims and rights.

Bank accounts

Security over Swiss bank accounts is typically provided by pledging the claims the account holder has against the account bank. An assignment for security purposes would also be possible (and would even be a slightly more direct security right), but account banks have become increasingly concerned in the past two years about 'know your customer' and beneficial owner identification issues, because the assignment is, legally, a full legal transfer, while the pledge only provides for a limited right *in rem*. As all account banks have priority rights in relation to the assets in the bank accounts, the pledge is, technically speaking and in the absence of a waiver of the account bank, second ranking. Therefore, to

perfect the pledge, a notification of the account bank is mandatory. Also, the account bank is requested to waive all priority rights in relation to the relevant bank accounts on the basis of its general terms and conditions and otherwise, but account banks do not always grant such waiver.

Timing of providing security on closing

The security interest provided by the acquisition vehicle may be entered into and perfected pre-closing, except for the share pledge, which may only be perfected upon closing of the transaction, immediately after the acquisition of the shares by the acquisition vehicle. From a Swiss point of view, there is nothing that would make it overly burdensome or impossible to perfect the security interest as soon as the transaction is completed or closed. However, some items (such as the amendment of articles of association or notices) will have to become post-closing items, but, as described above, that does not prevent the perfection of the security interest as such.

ii Standard target-level security package

Security is typically granted by the Swiss target companies. The target-level security package is similar to fully fledged security packages in other jurisdictions and may include, inter alia, security over:

1. shares in subsidiaries;
2. trade receivables;
3. intercompany receivables;
4. insurance claims;
5. bank accounts;
6. intellectual property; and
7. real estate.

See above for a description of security over most of these assets.

However, in smaller transactions and depending on the level of leverage provided, sponsors are sometimes able to negotiate a slimmer security package for purposes of avoiding transaction costs. This is particularly true in pure Swiss domestic deals and in case the taking of security would require involvement of additional foreign counsel. In addition, in Swiss domestic finance transactions, borrowers often are successful in negotiating slim security packages as a consequence of the strong negotiation power that borrowers currently have in the finance market.

Real estate

Security over real estate is typically taken by way of taking security over mortgage certificates. A mortgage certificate is issued either in bearer or in registered form. Alternatively, since January 2012, a paperless version of a mortgage note can be created which is evidenced by electronic registration in the relevant land register. A mortgage

note creates personal, non-accessory claim against the debtor, which is secured by a property lien. Unless pre-existing mortgage certificates are available, the creation of new mortgage certificates requires a notarised deed and registration of the mortgage certificate in the land register. Once created, the mortgage certificates will be transferred for security purposes under a written security agreement without further notarisation or entry into the land register (except in the case of paperless mortgage certificates).

One important tax point has to be considered as interest payments to non-Swiss resident creditors of loans secured by Swiss real estate are subject to withholding tax at source, unless the lender is located in a jurisdiction that benefits from a double tax treaty with Switzerland providing for a zero rate and the lender qualifies for treaty protection. Accordingly, if a Swiss borrower is involved, it must be ensured that only 'Swiss treaty lenders' will be secured by real property to avoid the risk of withholding tax being applied to interest payments. Swiss treaty lenders are persons:

1. having their corporate seat in Switzerland or are lending through a facility office (which qualifies as a permanent establishment for tax purposes) in Switzerland, and that are entitled to receive any payments of interest without any deduction under Swiss tax law; or
2. lending in a jurisdiction having a double tax treaty with Switzerland providing for a zero per cent withholding tax rate on interest payments and the lender qualifies for treaty protection.

In particular, owing to these tax issues, security over real estate is normally only considered if there is substantial real estate located in Switzerland.

If a foreign borrower is involved (such as a foreign acquisition vehicle), the issue basically remains the same, but an application for an exemption through a tax ruling application may be considered. While such a tax ruling has been obtained very recently in a few cantons, the process of being granted such a ruling in other cantons might be quite lengthy and, therefore, costly (while the outcome is possibly vague). Without a satisfactory tax ruling, real estate located in Switzerland cannot be granted as security owing to the risk of potential withholding tax on interest payments.

Intellectual property

Under Swiss law, security over intellectual property is typically taken by way of pledge. A written pledge agreement is required, specifying the intellectual property right. As a matter of Swiss law, no registration is required for the valid perfection of the pledge over intellectual property. However, if not registered, the intellectual property may be acquired by a bona fide third-party acquirer, in which case the pledge would become extinct. While a Swiss law pledge over foreign intellectual property is valid as a matter of Swiss law, it should be double-checked whether the validity of the security interest would also be recognised under relevant foreign law, or whether – as an example – its registration would be a perfection requirement. Accordingly, with regard to foreign intellectual property of certain importance and value, it is advisable to register the pledge in the relevant register. Security agreements typically provide for a registration obligation for the pledge over important

intellectual property on day one and for all other intellectual property upon the occurrence of an event of default.

Difficulties in taking security over movable assets

Owing to strict repossession requirements under Swiss law, taking of security over movable assets (such as an inventory or equipment) without substantially disturbing the daily business of the security provider is difficult. There are structuring solutions surrounding this issue (such as pledge holder structures or opco or propco structures), but these solutions are usually only implemented in situations where there is a specific focus on a specific asset (raw materials with substantial value, larger car fleets, aircraft parts, etc.).

Timing of providing target-level security

Unless there is some cooperation on the part of the seller to start preparing target-level security pre-closing (and depending on the exact release mechanisms from existing financings), target-level security might only be available post-closing, and it is usually agreed that target-level security might be completed as a condition subsequent.

iii Financial assistance and upstream and cross-stream security/guarantees

Standard upstream and cross-stream limitations will apply to Swiss target-level guarantees and security. Essentially, the amount of proceeds under upstream and cross-stream security or guarantees that is available to lenders is limited to the amount that the guarantor/security provider could distribute to its shareholders as dividends at the point in time of enforcement. In addition, certain formal requirements will have to be followed both, upon granting and enforcement of the security or guarantee. These limitations may affect the security substantially, particularly in situations of financial distress. However, if structured properly and if using all available mitigants, such limitations are generally accepted by investors and lenders.

In October 2014, the Swiss Federal Supreme Court ruled, that upstream and cross-stream loans that do not meet the at arm's-length test will also reduce the distributable amounts of the lender. However, at the same time, the Swiss Federal Supreme Court ruled that paid in surplus is generally available for distribution to shareholders. It would appear that parties have applied a more cautious approach around the granting of upstream and cross-stream loans since October 2014, but transaction structures generally remained unchanged. It remains to be seen whether further court rulings will be issued in this respect.

If the structure also includes a downstream loan from the acquisition vehicle to the Swiss target companies (often used for tax purposes as a pushdown of debt and for the repatriation of the cash flows), the Swiss target company may provide (unrestricted) security to secure such a downstream loan, because it would secure its own rather than parent debt. Accordingly, this would not qualify as upstream security. The acquisition vehicle in turn may provide security over the downstream loan, along with the (unrestricted) security package securing such a downstream loan. From a Swiss corporate law perspective, there is a good chance that upstream limitations will not apply to that security structure. However, such a security structure should be discussed with the Swiss Federal Tax Administration in the light of the Swiss Non-Bank Rules.

Priority of claims

i Statutory priority of claims

Upon bankruptcy over a Swiss entity, certain creditors would benefit from statutory priority:

1. secured claims are satisfied with priority directly out of the enforcement proceeds; any surplus will be shared among (unsecured) creditors generally, and any shortfall would be treated as a third-class claim; and
2. claims incurred by the bankruptcy or liquidation estate or during a debt restructuring moratorium with the administrator's consent rank above unsecured claims.

In relation to unsecured claims, there are three priority classes: the first class mainly consists of certain claims of employees as well as claims of pension funds; the second class consists of claims regarding various contributions to social insurances and tax claims; and the third class consists of all other unsecured claims.

ii Contractual structuring of priority of claims

Within the third class, creditors and the debtor are free to contract on the ranking of such claims among themselves. Typically, in Swiss acquisition finance transactions, the priority of claims among various debt investors is reflected on the basis of intercreditor arrangements rather than on the basis of structural subordination. It should be noted, however, that in larger transactions, the acquisition structure is most often set up outside Switzerland. In addition, where the investor base would expect a structural subordination, such a structure is implemented, but rather for marketing purposes.

Under Swiss law, intercreditor arrangements that provide for the priority of claims are generally binding on the parties involved and also on insolvency officials of an estate. However, given that there are hardly any relevant precedents, it cannot be ruled out that an insolvency official would treat all non-secured creditors indiscriminately as third-class creditors, and consider the priority of payments as a mere arrangement among creditors of the estate in relation to their respective claims in relation to the estate and pay them out on a pro rata and *pari passu* basis. Such being the case, the parties to the intercreditor arrangement may have to rely on the redistribution by the creditors among themselves.

iii Equitable subordination

The concept of equitable subordination is neither reflected in codified Swiss law nor well established in Switzerland. Even though there are no conclusive precedents, equitable subordination is generally only discussed in connection with shareholder loans. It is unclear whether the holding of a very small equity stake would be sufficient for a qualification of a loan as shareholder loan. It would appear that the terms of the loan and the circumstances under which it has been granted are more relevant than the specific percentage of shareholding. Against this background, it may be concluded that a loan

granted in proportion to the shareholding of a small shareholder (together with all other shareholders) could be problematic, while the holding of a portion in a larger (syndicated) loan (at arm's length) by a bank seems to be unproblematic, even if that bank would hold an equity stake in the relevant Swiss company.

Basically, a parent company will be treated as any other third-party creditor of such Swiss subsidiary in the framework of a Swiss bankruptcy proceeding. The risk of a shareholder loan being deemed to be either subordinated against all other (non-subordinated) creditors, or to be treated like equity (in which case, the parent company would only be satisfied together with all other equity contributors), arises only under very specific circumstances.

Elements that could be relevant are:

1. that the shareholder loan is granted in a situation where the Swiss subsidiary is already over-indebted;
2. that the parent company had (or should have had) knowledge of the over-indebtedness of its Swiss subsidiary while granting the shareholder loan;
3. that the granting of the shareholder loan resulted in the Swiss subsidiary having upheld its business activities, and accordingly in a deferral of the opening of bankruptcy proceedings over the Swiss subsidiary; and
4. that the deferral of the opening of bankruptcy proceedings results in a (potential) damage of other creditors of the Swiss subsidiary.

A few scholars suggest applying a stricter regime (per se subordination of shareholder loans in bankruptcy; application to the concept to third-party loans, etc.), but it must be noted that court decisions where the concept of equitable subordination has been applied are fairly rare and, accordingly, that this concept cannot be regarded as well established as such. Therefore, we see little leeway for the application of such a concept, in particular, where loans are granted on an arm's-lengths basis and to Swiss companies that are not over-indebted.

Jurisdiction

The submission by a Swiss company to the exclusive jurisdiction of the courts of any other non-Swiss forum is generally binding on such a Swiss company. It should be noted, however, that under Swiss law, jurisdiction clauses may have no effect as regards actions relating to, or in connection with, insolvency procedures that, as a rule, must be brought before the court at the place of such an insolvency procedure. Furthermore, contractual submissions to a particular jurisdiction are subject to the mandatory provisions on the protection of consumers, insured persons and employees pursuant to the Lugano Convention, the Swiss Federal Private International Law Act (PILA) and such other international treaties by which Switzerland is bound. Pursuant to the PILA and the Lugano Convention, Swiss courts may also order preliminary measures even if they do not have jurisdiction over the substance of the matter.

Until 31 December 2020, the Lugano Convention was applicable for jurisdiction and the recognition and enforcement of judgments in civil and commercial matters also in relation to England. Under the Lugano Convention, jurisdiction clauses referring to the 'courts of

England' were valid since there is no specific requirement under the Lugano Convention to refer to a specific forum or a forum of a specific place. As a consequence of Brexit, the Lugano Convention no longer applies in matters involving England as from 1 January 2021 and any jurisdiction clause entered into by a Swiss company and to be reviewed by Swiss courts would be reviewed under the PILA. Other than under the Lugano Convention, under the PILA, a jurisdiction clause must at least determine a place or city, rather than just a country. If a jurisdiction clause does not meet these requirements and refers to the courts of a country only, there is some uncertainty about whether it would be held valid and enforceable in Switzerland. Therefore, it is advisable that such jurisdiction clauses refer to a specific city, rather than just to the courts of a country.

Enforceability in Switzerland of a foreign judgment rendered against a Swiss company is subject to certain limitations set forth in: (1) the Lugano Convention; (2) the other international treaties under which Switzerland is bound; and (3) the PILA. In particular, a judgment rendered by a foreign court may only be enforced in Switzerland if:

1. in the case of (2) and (3) and, in certain exceptional cases, (1), the foreign court has jurisdiction;
2. the judgment of such foreign court has become final and is non-appealable or, in the case of (1), has become enforceable at an earlier stage;
3. the court procedures leading to the judgment followed the principles of due process of law, including proper service of process; and
4. the judgment of the foreign court on its merits does not violate Swiss law principles of public policy.

In addition, enforceability of a judgment by a non-Swiss court in Switzerland may be limited if the Swiss company demonstrates that it has not been effectively served with process (a service of process on the Swiss company will have to be made in accordance with the Hague Convention).[2]

Outlook

According to macro-economy experts, most countries are likely to fall into a recession in Q4 2022 until Q2 2023. Accordingly, it may be expected that acquisition and leveraged finance will go through a challenging time. In addition, it is expected that in Switzerland a fair number of transaction will have to be restructured.

Endnotes

1 Lukas Wyss and Maurus Winzap are partners at Walder Wyss Ltd. ^ Back to section

2 The Hague Convention of 15 November 1965 on service of judicial or extrajudicial documents abroad in civil and commercial matters. ^ Back to section

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Introduction

London maintains its position as a leading market for leveraged finance transactions, with English law frequently governing finance documentation for both European and other international leveraged finance transactions.

There is continued diversity both in terms of the range of financial instruments (including high-yield bonds, syndicated loans, unitranche or direct lending financings, second lien, super senior, and payment-in-kind financings and preferred equity), and the sources of financing available to borrowers (including commercial and investment banks, institutional lenders and private capital). Credit funds have continued, through unitranche and direct lending financings, to gain increased market share in European leveraged transactions, with greater prevalence in the large cap market in addition to the more traditional mid-market where these funds predominantly operate.

European covenant-lite structures (loans with high-yield bond-style incurrence covenants and no maintenance financial covenants) are now customary in large cap syndicated loans, particularly on sponsor-led transactions. Although most financings by private capital providers still carry maintenance covenants, covenant-lite unitranches and senior direct lending are becoming a feature of the private credit market as private capital providers gain market share in the large cap segment of the leveraged finance market.

Year in review

There was a continued slowdown in M&A linked debt issuance in 2023 due to challenging market conditions. At the start of the year, the market grappled with the aftermath of the successive changes in Prime Minister and the mini-budget announcement late last year, as well as ongoing geopolitical tensions and macroeconomic uncertainty. The challenges faced by the market were then compounded by the spectre of a banking crisis in March, continuous interest rate hikes in response to inflationary pressures and the buyer-seller valuation gap.

Banks also continued to take a cautious approach to underwriting following a number of failed syndications in 2022, and the choppy market conditions made primary markets difficult to navigate. This resulted in more dealmaking opportunities for private capital providers, who stepped in to fill the void left by underwriting banks and institutional lenders and were instrumental in providing innovative solutions as companies sought to manage their balance sheets and liabilities, as well as secure liquidity amid the increasing cost of debt. Increasingly, issuers and sponsors now run dual-track processes that explore both syndicated and direct lending alternatives in tandem to obtain the best terms possible.

As the M&A pipeline was thin on the ground, amend and extend and add-on processes dominated issuances for most of the year. The challenging market conditions, however, provided some compelling opportunities for sponsors to deploy capital. Depressed equity valuations of publicly listed companies resulted in notable public to private (P2P) transactions in the United Kingdom. The relative strength of the dollar versus sterling also made UK P2Ps an attractive investment for US investors. Notably, private capital providers were the preferred route for financing certain P2P transactions this year, providing the certainty of funds required and clubbing together to finance larger transactions.

It would also be remiss not to mention that 30 June 2023 saw the last panel bank fixing for USD LIBOR, a momentous date for the leveraged finance market as it moves into an era of risk-free rates.

Regulatory and tax matters

i Regulatory matters

The Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) are the financial regulators in the United Kingdom. The PRA is part of the Bank of England and authorises and prudentially supervises banks, building societies, credit unions, insurers and major investment firms. The FCA is responsible for authorising and prudentially supervising other firms that undertake regulated financial services activities, and for supervising all regulated financial services firms from a conduct of business perspective.

Cash loans to businesses are largely unregulated in the United Kingdom, unlike consumer lending or residential mortgages. Therefore, providing a secured or unsecured loan to, or subscribing for a secured or unsecured debt instrument issued by, an entity that is incorporated or tax-resident in the United Kingdom is not considered a regulated activity and does not require any kind of banking or similar licence or approval. It is important to note, however, that because much of this activity is carried out by businesses that are regulated for other purposes (banks and investment firms), there may be broader regulation impacting them that may impact the terms of any loan. Similarly, borrowers who are themselves regulated may have restrictions on the nature or scope of security they can offer owing to financial regulation affecting their business (in particular, regulatory capital requirements). More complex forms of lending, such as arranging the issuance of, or transacting in, debt instruments that embed derivatives or underwriting a bond issuance would constitute regulated activities, requiring the financial institutions offering those services to comply with regulatory obligations.

The United Kingdom left the European Union on 31 January 2020 (Brexit), and the transition period during which EU legislation continued to apply in the United Kingdom ended on 31 December 2020. Finance providers in the United Kingdom previously relying on EU passporting rights to provide financial services in the European Union while being a regulated entity in the United Kingdom now have to analyse if they require any local licences for financial transactions into the European Union.

Borrowers and lenders are subject to the anti-money laundering and sanctions regimes in the United Kingdom, and will also need to take into account anti-corruption legislation.

ii Tax matters

Three areas of taxation are particularly significant in the context of leveraged finance transactions:

1. withholding tax on payments of interest to the lender;
2. the deductibility of interest for the borrower; and

3. tax issues on the enforcement of security.

iii Withholding tax

Payments of yearly UK source interest are subject to UK withholding tax at the basic rate of 20 per cent. There are, however, a number of exemptions from the charge to withholding tax, with the following being the most commonly used:

1. Exemption from withholding tax relating to the nature of the lender: corporates and banks that are taxed in the United Kingdom may receive interest gross, given the income of these lenders is taxable in the United Kingdom in any event. Advances from building societies are also generally free of withholding tax on interest.
2. Exemption relating to the nature of the security: the 'private placement' exemption entitles the holder of privately placed securities to interest free of withholding tax, provided the requirements are met, including the term of the security being less than 50 years and the security having a minimum value of £10 million. Additionally, the 'quoted Eurobond' exemption enables the holder of a security to receive interest free of withholding tax, provided the security is issued by a company and listed on a recognised stock exchange or admitted to trading on a multilateral trading facility.
3. Exemption relating to double taxation treaties between the United Kingdom and other jurisdictions: the United Kingdom has entered into a number of treaties with other jurisdictions, which provide for a nil rate of withholding tax in the United Kingdom. Non-UK lenders tax resident in such jurisdictions are entitled to receive interest free of withholding tax. There is an administrative burden involved in relying on this exemption, since it must be claimed, and interest may only be paid free of withholding once a borrower has received an instruction from HM Revenue and Customs (HMRC). Furthermore, a claim under the normal certification process can take several months. The double taxation treaty passport scheme, however, grants certain lenders a 'passport', thereby streamlining the otherwise lengthy certification process.

The broad nature of the above exemptions gives significant flexibility, enabling UK borrowers to raise funds from different types of lenders, and different types of security. In particular, the 'quoted Eurobond' exemption enables capital to be raised from offshore funds, which would usually not be capable of benefiting from double taxation treaties with the United Kingdom, as the latter will generally not provide for a nil rate of withholding tax in treaties with tax haven jurisdictions.

iv Deductibility of interest

As a starting point, interest incurred by a UK corporate borrower is, under the loan relationship rules, deductible in calculating taxable profits. The loan relationship provisions, as a general rule, follow the accounts. This means that the amounts recognised in determining a company's profit or loss under generally accepted accounting practice will usually constitute credits and debits under the loan relationship rules. Interest on a loan is a debt service cost to the borrower, and this classification is the starting point

for interest-related tax deductions. There are, however, rules that can restrict or prevent the deductibility of interest to be borne in mind, as interest deductibility is often a key commercial driver of debt financings. Three important examples are set out below, but there are other relevant restrictions beyond the scope of this chapter; for example, the unallowable purposes rule, the targeted anti-avoidance rule and rules re-characterising interest as a distribution.

1. Corporate interest expense restriction rules limit the amount of interest expense large businesses can deduct when calculating their profits subject to corporation tax. Broadly, the rules place a cap to limit deductions to 30 per cent of a group's UK 'tax EBITDA', or alternatively a modified debt cap is imposed that ensures that a group's UK interest deductions cannot exceed the total net interest expense of the worldwide group. Net interest expenses under the *de minimis* allowance of £2 million will not be restricted by the rules.
2. Where transfer pricing rules apply to a loan (particularly relevant in the context of related-party borrowing arrangements), they operate to deny the borrower a tax deduction for any part of the interest that exceeds an arm's-length rate of interest. The terms, amount and availability of the debt will be readjusted (for tax purposes) to those of an arm's-length transaction.
3. Corporate income loss restriction limits the amount of post-1 April 2017 profits against which carried-forward losses incurred in any period could be relieved to 50 per cent of profits over an annual allowance of £5 million. Since 1 April 2020, however, the relief provided by the £5 million annual allowance is shared between both carried-forward corporate income losses and carried-forward corporate capital losses.

v Enforcement of security

Tax grouping enables UK group members to allocate gains and surrender losses between members of the group on a current year basis. This enables deductible interest to be set off against the income generated by another group member, meaning borrowing need not be engaged in by an income-generating company within the group. Furthermore, the group rules allow for assets to be transferred within the group on a 'no gain, no loss' basis. Where these assets are transferred outside of the group (e.g., upon the enforcement of security by a lender), de-grouping charges may arise to tax any latent capital gains realised prior to the external transfer.

Security and guarantees

Taking English law security is relatively straightforward and security can be taken over most asset classes. Security is granted to a security trustee (commonly also referred to as a security agent) to hold the security interests on trust for the secured creditors, allowing new lenders and other creditors coming into the transaction to continue to benefit from the security without the risk of restarting hardening periods associated with taking new security.

The nature of the security taken (whether charge, mortgage or pledge) is a function of the asset in question and the commercial agreement as to the security package.

Security in leveraged finance transactions is typically created either by way of a charge, which is an equitable interest in the asset, or by way of a mortgage, which involves transfer of title. A charge can be either 'fixed' or 'floating', depending on the degree of 'control' that the lenders have over the assets, with 'control' being a fact-specific assessment of the lenders' ability to prevent the security provider from dealing with the charged asset. A fixed charge can be taken over specific assets, whereas a floating charge is taken over a fluctuating pool of assets. Until a floating charge crystallises into a fixed charge upon the occurrence of certain common law or contractually agreed events, the grantor of a floating charge is allowed to deal with the floating charge assets in the ordinary course of business. A floating charge will not 'crystallise' on the occurrence of a moratorium under the Corporate Insolvency and Governance Act 2020.

Security over 'financial collateral' such as shares and cash can also benefit from the Financial Collateral Arrangements (No. 2) Regulations 2003, which disapply certain statutory formalities and modify certain insolvency law provisions in respect of such a 'security financial collateral arrangement' and the lender can 'appropriate' the secured asset if the security becomes enforceable.

Depending on the asset and the nature of security interest, certain steps may need to be taken to perfect the security. English law perfection and registration steps are fairly straightforward, inexpensive and help to protect the priority of the secured creditors. Additionally, subject to limited exceptions, security granted by English companies or limited liability partnerships (LLPs) must be registered at Companies House within 21 days of its creation or it will be void against creditors, administrators and liquidators of that company or LLP.

English law insolvency rules dealing with the priority of security interests are complex and depend on, among other factors, the nature of security interest (whether a fixed or floating charge or legal or equitable security), timing of security (second in time, second ranking) and whether security has been perfected. In addition, where an English company has entered into a formal insolvency process, certain types of 'antecedent' or 'reviewable' transactions entered into by that company before the commencement of the insolvency process may be challenged by the insolvency officeholder. The period for reviewing such 'antecedent' transactions ranges from six months to three years, although there is no time limit within which a challenge to a transaction defrauding creditors may be brought, which, in short, requires the purposeful alienation of assets from creditors.

Upstream, downstream and cross-stream guarantees are generally available under English law. When dealing with upstream and cross-stream guarantees, the board of directors of the guarantor must carefully consider the corporate benefit to the guarantor, keeping in mind the financial position of the guarantor. It is therefore not uncommon to obtain shareholder approval to support the giving of such upstream and cross-stream guarantees.

Priority of claims

In a corporate insolvency, creditors will be paid in accordance with the following 'waterfall' of priority under law from proceeds of realisation of assets of the insolvent estate:[2]

1. First, creditors holding a fixed charge (but only to the extent of the value of the applicable secured assets): as discussed above, a fixed charge requires the lender to retain a level of control of such assets. If the chargor is authorised to deal with the charged assets in the ordinary course of business, the charge could be re-characterised as a floating charge (notwithstanding any designation of the charge as 'fixed' by the parties), and the priority of the lender's claim will be affected accordingly. The proceeds of the realisation of the assets subject to a fixed charge will be paid to the holder of that fixed charge.
2. Second, creditors of 'moratorium debts' and 'priority pre-moratorium debts': if a company goes into administration or liquidation, in each case within 12 weeks of the end of a moratorium under Part A1 of the Insolvency Act 1986, any debts that are incurred during the moratorium and certain debts incurred before the moratorium (such as the monitor's remuneration or expenses, rent during the moratorium or non-accelerated financial debt) (if the company is in liquidation, fees of the official receiver will take priority over these debts).
3. Third, fees and expenses of the insolvent estate incurring during the relevant insolvency proceedings (there are statutory provisions setting out the order of priority in which expenses are paid).
4. Fourth, ordinary and secondary preferential creditors: ordinary preferential debts include (but are not limited to) debts owed by the insolvent company in relation to: contributions to occupational and state pension schemes; wages and salaries of employees for work done in the four months before the insolvency date, up to a maximum of £800 per person; and holiday pay due to any employee whose contract has been terminated, whether the termination takes place before or after the date of insolvency. Secondary preferential debts rank equally between themselves for payment after the discharge of ordinary preferential debts and include claims by HMRC in respect of certain taxes including VAT, PAYE income tax (including student loan repayments), employee NI contributions and Construction Industry Scheme deductions (but excluding corporation tax and employer NI contributions) that are held by the company on behalf of employees and customers.
5. Fifth, creditors holding a floating charge: the proceeds of the realisation of the assets subject to the floating charge will be paid to the holders of the floating charge. Where the floating charge was created after 15 September 2003, a portion (or 'prescribed part') of the charged assets is made available for the satisfaction of unsecured creditors' claims, subject to a cap of £800,000 where the floating charge is created on or after 6 April 2020 or £600,000 if created before then.
6. Sixth:
    - provable debts of unsecured creditors and any secured creditor to the extent of any remaining debt due to it (a shortfall), in each case, including accrued and unpaid interest on those debts up to the date of commencement of the relevant insolvency proceedings;
    - interest on the company's debts (at the higher of the applicable contractual rate and the official rate in accordance with the Judgments Act 1838)

in respect of any period after the commencement of liquidation, or after the commencement of any administration that had been converted into a distributing administration; and

- non-provable liabilities, being liabilities that do not fall within any of the categories above and therefore are only recovered in the (unusual) event that all categories above are fully repaid.

7. Seventh, shareholders: members of the company may receive any surplus funds following the satisfaction of all creditors' claims.

Contractual subordination via the use of intercreditor or subordination agreements to govern claims between various third-party creditors and also between third-party creditors and any intra-group creditors (including shareholder claims) is commonplace, and case law has held that they do not inherently offend the above rules of priority or other English insolvency principles of distribution.

Jurisdiction

Prior to Brexit, the law governing contractual and non-contractual obligations arising out of and in connection with a particular contract was, as a matter of English law, ascertained pursuant to Regulation (EC) No. 593/2008 on the Law Applicable to Contractual Obligations (Rome I) and Regulation (EC) No. 864/2007 on the Law Applicable to Non-Contractual Obligations (Rome II). Both of those pieces of legislation were retained as part of English law following Brexit (by the Law Applicable to Contractual Obligations and Non-Contractual Obligations (Amendment etc) (EU Exit) Regulations 2019) such that, in essence, the Rome I and Rome II Regulations provide a governing law playbook of near universal application in the context of claims in the English courts.

In very broad terms, both the Rome I and Rome II Regulations (as retained in English law) allow parties to choose freely the law applicable to their contractual obligations and their non-contractual obligations. Where no choice is made, contractual obligations are generally governed by the law of the country where the party required to effect the characteristic performance of the contact has their habitual residence, and non-contractual obligations are generally governed by the law of the country in which damage occurs.

As to jurisdiction, in the context of the leveraged finance market in England and Wales, disputes between the parties are typically referred to the courts. Whether a court has jurisdiction can be decided by the courts themselves, although contracting parties almost always include a jurisdiction clause in their agreement that allows them to choose which court has jurisdiction (and such provisions will be given effect by the English courts).

There are three principal types of jurisdiction clauses:

1. an exclusive jurisdiction clause specifies a jurisdiction in respect of disputes and prevents either party from bringing proceedings against the other in the courts of any jurisdiction other than the one specified;
2. a non-exclusive jurisdiction clause enables either party to bring proceedings against the other in the courts of the chosen jurisdiction or in the courts of any other

jurisdiction (provided any alternative court has jurisdiction over the dispute under its own rules); and

3. an asymmetric jurisdiction clause permits one of the parties to sue the other party in any competent jurisdiction but restricts the other party to bringing proceedings in only one jurisdiction.

Brexit has had an impact on issues of jurisdiction, and on the enforcement of English judgments in Europe (arbitration clauses and proceedings are unaffected by Brexit). Regulation (EU) No. 1215/2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (the Recast Brussels Regulation) regulates jurisdiction and the recognition and enforcement of judgments between EU member states, but no longer applies in the United Kingdom post-Brexit. That means that whether the English courts will take jurisdiction now depends on the satisfaction of one of the 'jurisdictional gateways' set out in Practice Direction 6B of the Civil Procedure Rules (in practice, the English courts are now able to take jurisdiction in a wider set of circumstances than might have been the case under the Recast Brussels Regulation). That also means that the simple and convenient route to the enforcement of English judgments in EU member states no longer exists.

The United Kingdom has acceded to the Hague Convention on Choice of Court Agreements 2005. Courts of the parties to the Hague Convention, including EU member states, will respect exclusive jurisdiction clauses and enforce judgments from courts selected pursuant to those clauses. The Hague Convention does not, however, cover non-exclusive jurisdiction clauses or asymmetric jurisdiction clauses (or judgments resulting from the operation of those kinds of clauses). In order to improve the position with regard to the enforcement of English judgments, the United Kingdom applied to join the Lugano Convention in early 2020, but the accession process has been blocked by the European Commission (and it is unclear when the position will change, despite the United Nations writing to the European Commission in March 2023 seeking an adjustment of the European Commission's position).

In practice, however, English judgments may still be enforced with relative ease in EU member states, even without the Recast Brussels Regulation. That is either because there is a reciprocal relationship with the relevant country or that country generally allows enforcement without significant hurdles.

Acquisitions of public companies

Where the City Code on Takeovers and Mergers (the Takeover Code) applies to the acquisition of a UK public company, there are additional considerations for lenders. The provisions of the Companies Act 2006 (CA 2006), which regulate the giving of financial assistance by public companies in relation to the acquisition of their own shares (as further described below), and which contain the requirements in relation to the compulsory acquisition of minority interests, can also be relevant.

There are two principal mechanisms to effect a takeover of a UK public company: a contractual offer to all of a target's shareholders to acquire their shares; and a court-approved scheme of arrangement, which is a statutory mechanism involving a target

shareholder vote and court approval. A significant majority of UK takeovers use the latter method.

The Takeover Code, which is administered by the Panel on Takeovers and Mergers (the Takeover Panel), applies to any takeover offer or scheme of arrangement to acquire:

1. a public company registered in the United Kingdom, Channel Islands or the Isle of Man, which either:
    - has shares admitted to trading on the London Stock Exchange's Main Market, AIM or certain other regulated markets; or
    - is considered by the Takeover Panel to have its place of central management and control in the United Kingdom, Channel Islands or the Isle of Man; and
2. in certain situations set out in the Takeover Code, any private company registered in the United Kingdom, Channel Islands or the Isle of Man that has had its shares admitted to trading on those markets in the past 10 years.

It sets out detailed rules on the process and timetable for conducting UK takeovers. In particular, it requires strict secrecy concerning any potential offer and also provides that a bidder must announce a bid only after ensuring that it has the funds to meet in full any cash consideration offered.

The Takeover Code's strict requirements in relation to secrecy and bid confidentiality mean that the bidder's approach to sharing information with its advisers and other third parties and due diligence on the target can differ from that taken on private acquisitions. If details of the bid leak to the market, the Takeover Panel may require the bidder to make an immediate holding announcement and to confirm within 28 days whether it intends to make a binding offer for the target. Where triggered, this 28-day 'put up or shut up' period can limit the time a bidder has to undertake due diligence (although the 28-day period may be extended with the consent of the target). For hostile takeovers, lack of cooperation by the target will mean that the bidder's and lenders' due diligence will be limited to information available from public sources or third parties. For bids that are expected to be recommended by the target board, more extensive due diligence may be carried out. However, sensitivity around potential leaks, the related timetable pressures and the Takeover Code requirement that information provided to one bidder must, on request, be provided to other (potentially less welcome) bidders can mean that due diligence for public company acquisitions may not be as extensive as for private acquisitions.

Rules that require equality of information between target shareholders can also give rise to issues where a lender is also, or could become, a shareholder in the target; for example, where a bank has a trading desk or a fund has an equities business. These issues can be addressed if the lender confirms in the relevant NDA it has effective information barriers in place between the lender's debt and equities businesses or if the potential provider of debt finance represents that it does not hold any shares in the target (and undertakes not to acquire any shares in the target during the offer period, subject to technical exceptions to permit the acquisition of shares in client serving capacities or (with the consent of the Takeover Panel) as security for a loan made in the normal course of business).

In the case of any bid including a cash consideration element, the announcement must include a confirmation by the bidder's financial adviser or by another appropriate third party that, so far as they are reasonably able to ensure, resources are available to the bidder sufficient to satisfy full acceptance of the offer (including any cash consideration to be paid to option and warrant holders in the target). This 'cash confirmation' is also required to be repeated in the subsequent offer or scheme document when it is made available to shareholders, normally required to be within 28 days after the firm offer announcement. This is driven by a fundamental tenet of the Takeover Code that there is maximum certainty an announced bid will go ahead.

Because there is a theoretical risk that the financial adviser may be required by the Takeover Panel to fund the offer if the bidder does not have sufficient resources and the financial adviser has not exercised the appropriate standard of care required by the Takeover Code in giving the 'cash confirmation', the bidder's financial adviser will generally require fundable and largely unconditional debt and equity documentation to have been signed before the announcement is made. Financial advisers are normally willing to provide a cash confirmation on the basis of short-form interim loan agreements (in relation to any debt funding) and an equity commitment letter (in relation to any equity funding) put in place at announcement, with the long-form documentation to be negotiated and entered into subsequently. The financial adviser will also be concerned with ensuring that the bidder's financing is available for a sufficient period to cover the range of possible closing dates for the transaction. Following amendments to the Takeover Code that took effect in July 2021, it has been suggested that the relevant periods should extend to the date falling eight weeks after the transaction long-stop date in the case of a contractual offer, and six weeks after the transaction long-stop date in the case of a scheme of arrangement.

The Takeover Code requires the disclosure of any debt facility documentation (including fee letters) at the time a firm intention to make an offer is announced. When published, the offer document must include details of the terms of any financing arrangements. Where a bidder's financing includes syndication-related flex arrangements, the Takeover Panel will typically agree to a delay (by way of redaction) in disclosing the flex terms until the offer document is posted to shareholders. If the flex terms are no longer capable of being exercised at that point in time (e.g., because successful syndication has been achieved), the flex disclosure may be omitted. However, if the debt is not syndicated by that time, the flex arrangements must be described in the offer document and the full terms published on the target's website.

The Takeover Panel requires that, prior to announcement, a bidder may only impart confidential information in relation to a bid to another person 'if it is necessary to do so'. The Takeover Panel interprets this requirement restrictively, and ordinarily a bidder must consult the Takeover Panel before disclosing the possibility of a bid beyond a very limited number of parties, usually no more than six entities outside of the bidder's advisory team, including potential finance providers (whether equity or debt) and shareholders in the bidder or the target.

While a scheme of arrangement will be binding on all target shareholders if approved by the requisite majority, with a takeover offer the bidder may receive acceptances for less than 100 per cent of the shares in the target. Provided that the bidder receives acceptances for 90 per cent of the shares to which the offer relates, it will usually be able to utilise the

minority squeeze-out procedure under Section 979 of CA 2006 to compulsorily acquire the remaining shares.

Where the 90 per cent threshold is not obtainable, provided the bidder acquires at least 75 per cent of the target's voting shares, it would be able to pass the special resolutions of the target necessary to cancel the target's listing, re-register it as a private limited company and cause it to give financial assistance for the acquisition of its shares. Consequently, financing terms will often include a minimum acceptance threshold, usually ranging between 75 and 90 per cent, to ensure control or a minority squeeze-out can be achieved.

Under CA 2006, public limited companies incorporated in England are restricted from giving financial assistance for the acquisition of, or (re)financing the acquisition of, shares in the company. The subsidiaries of such companies are also restricted (regardless of whether they are public limited companies) from giving such financial assistance. This prohibition on financial assistance includes upstream guarantees and security from the target and its English incorporated subsidiaries to secure the bidder's financing for the acquisition of shares in an English incorporated public limited company. These principles do not, however, restrict the bidder's ability to grant security over any shares in the target that it holds, provided that security does not involve any element of assistance by or from the assets of the target. In addition, they do not restrict the ability of the target to give guarantees and security for the portion of the financing that is to be made available to the target. These financial assistance limitations do not apply to private limited companies. Accordingly, lenders financing a UK takeover will typically require that, once the offer has successfully completed, the target will have its listing cancelled and be re-registered as a private limited company.

Outlook and conclusions

Despite the turbulence faced by the acquisition and leveraged finance market this year, the market is resilient and debt financing has remained available for the right credits, albeit with lower leverage multiples and higher pricing compared to prior periods. Market participants will continue to look to more creative solutions to manage capital structures in light of evolving risk management processes and the higher interest rate environment. This may provide an impetus for private capital providers to continue to build on their market share. While the current macroeconomic climate makes for a more cautious dealmaking environment, the deal pipeline is rebuilding and the outlook is somewhat more optimistic after a tumultuous couple of years. Underwriting banks are showing renewed appetite, there are healthy levels of liquidity available and, with sponsors looking to deploy the record levels of dry powder, there are encouraging signs that there will be more robust levels of activity next year.

Endnotes

1 Tracy Liu is a member of the banking practice and Yien Ee is a knowledge management counsel in the banking group at Latham & Watkins LLP in London. ^ Back to section

2 The insolvent estate of a company does not include property in which the company does not have a beneficial interest. So, for example, assets subject to a valid retention of title claim or which the company holds on trust for a third party will not fall within the insolvent estate. ^ Back to section

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Introduction

Leveraged acquisitions are typically financed through a mixture of high-yield bonds and term loans, with ongoing working capital requirements provided through cash flow or asset-backed revolving facilities entered into concurrently with the acquisition. Financings utilising term loans and revolving facilities are typically guaranteed by each material wholly owned domestic subsidiary of the borrower and secured by substantially all the assets of the borrower and each guarantor. The sources of funding are broad, including collateralised loan obligations and other institutional lenders, retail loan funds, direct lenders and commercial banks. According to *Refinitiv LPC*, US syndicated loan market volume in 2022 was US$2.4 trillion, a 15 per cent decrease compared with 2021's US$2.9 trillion. Leveraged loans accounted for US$850 billion of syndicated volume in 2022, a 35 per cent decrease over 2021's US$1.31 trillion. *KBRA Direct Lending Deals* reported that total volume of sponsored, cash-flow-based direct lending in 2022 was US$144.8 billion, up 31 per cent from US$110.3 billion in 2021.

Year in review

The year 2022 started off on an optimistic note, but with the war in Ukraine and other macroeconomic pressures, the situation took a turn. Issuance fell due to a slowdown in M&A activity and tough market conditions. Fear of a recession created a bifurcated market, with higher rated borrowers able to access financing and lower rated companies shut out, particularly in the second half of the year.

Regulatory and tax matters

i Regulatory issues

Regulatory concerns for debt finance in the leveraged acquisition context typically arise under regulations related to authorisation and sanctions. Certain types of collateral may also be subject to special regulations. In addition, there are regulatory limitations applicable to certain leveraged finance activities of banks.

Required authorisation

Assuming the lender does no other business in the United States, being a lender of record for commercial lending generally does not subject the lender to licensing or other qualification requirements to do business in the United States, although there may be exceptions to this rule from state to state. Collection and enforcement activities are more likely to require an entity to obtain a licence and qualify to do business within a state. However, in almost all leveraged acquisition financing, only the administrative agent (or collateral agent) will be acting in the capacity of the collecting or enforcing bank, and these restrictions are generally not a concern for specific syndicate members.

Sanctions

Federal sanctions and anti-money laundering laws require financial institutions to implement due diligence procedures with respect to their customers to prevent the transfer of cash to certain prohibited countries and persons.

Collateral-related regulations

Margin loans

If the collateral for the loan consists of securities that are traded on an exchange in the United States, or 'margin stock', the loan may be subject to additional restrictions. These restrictions, often referred to as the 'margin regulations', limit the amount of loans that can be collateralised by securities. The US margin regulations can also be implicated by the existence of arrangements that constitute indirect security over margin stock, such as through negative pledge provisions or other arrangements that limit a borrower's right to sell, pledge or otherwise dispose of margin stock.

Government receivables

With respect to collateral consisting of receivables, if the debtor under such receivable is the US government or one of its agencies or instrumentalities, the federal Assignment of Claims Act will apply to an assignment of receivables and the right of the federal government to exercise set-off. A minority of states have similar laws that apply to obligations of the state or agencies or departments thereof, and a few states extend these rules to municipalities and other local governmental entities.

Regulatory developments – leverage lending guidance

In March 2013, the three US federal banking agencies, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve) and the Federal Deposit Insurance Corporation (FDIC) jointly issued updated supervisory guidance for financial institutions engaged in leveraged lending activities, including acquisition financing. The leveraged lending guidance sets forth enhanced expectations in a number of areas and cautions banks to strengthen their risk management of loans to highly leveraged borrowers. Although different US administrations since 2013 have taken differing views on the extent to which 'guidance' has the same legal effect as a regulation, the initial implementation and continued application of the leveraged lending guidance has curtailed the ability of entities subject to regulation by one of the three US federal banking agencies to commit to certain highly leveraged transactions.

ii Tax issues

Withholding taxes

The United States generally imposes a 30 per cent federal withholding tax on interest paid to a non-US lender on a debt obligation of a US person (and certain non-US persons engaged in a trade or business in the United States). This withholding tax may be eliminated

(or reduced to a lesser amount) pursuant to an applicable income tax treaty between the United States and the country in which a lender receiving interest is resident.

Alternatively, a non-US lender may qualify for an exemption from US federal withholding on interest under the 'portfolio interest exemption'. To qualify for the portfolio interest exemption:

1. the debt obligation must be in 'registered form' for US federal income tax purposes;
2. the lender must not be a controlled foreign corporation related to the borrower or a bank receiving interest on an extension of credit entered into in the ordinary course of its trade or business; and
3. the lender must not own, directly, indirectly or by attribution, equity representing 10 per cent or more of the total combined voting power of all voting stock of the borrower (or, if the borrower is a partnership, 10 per cent or more of capital or profits interest of the borrower).

In addition, the portfolio interest exemption does not apply to certain contingent interest, such as interest determined by reference to any receipts, sales, cash flow, income or profits of, or the fluctuation in value of property owned by, or dividends, distributions or similar payments by, the borrower or a related person.

The beneficial owner of interest must generally submit a properly completed Internal Revenue Service (IRS) Form W-8BEN-E (or, if an individual, IRS Form W-8BEN) to claim an exemption or reduction available under an applicable income tax treaty or the portfolio interest exemption.

If interest paid to a non-US lender is effectively connected with the lender's trade or business in the United States, the interest will not be subject to US federal withholding as long as the lender submits a properly completed IRS Form W-8 ECI (or other applicable form), but will generally be subject to net income tax in the United States and, for foreign corporations, branch profits taxes.

Additionally, withholding taxes may arise in other circumstances, including the payment of various fees (such as letter of credit fees), modifications to debt obligations and certain adjustments to conversion ratio on debt obligations that are convertible into stock.

Foreign Account Tax Compliance Act

Under provisions in the Foreign Account Tax Compliance Act (FATCA), a 30 per cent withholding tax may be imposed on interest on and, subject to the proposed Treasury Regulations discussed below, gross proceeds from the sale, redemption, retirement or other disposition of a debt obligation of a US person (and certain non-US persons engaged in a trade or business in the United States) paid to a foreign financial institution or to a non-financial foreign entity, unless:

1. the foreign financial institution enters into an agreement with the IRS and undertakes certain investigation, reporting and other required obligations;
2. the non-financial foreign entity either certifies it does not have any substantial US owners or furnishes identifying information regarding each substantial US owner; or

3. the foreign financial institution or non-financial foreign entity otherwise qualifies for an exemption from these rules.

Foreign financial institutions located in jurisdictions that have an intergovernmental agreement with the United States governing these rules may be subject to different rules. FATCA withholding tax generally applies to payments of US-source interest made on or after 1 July 2014, and to payments of gross proceeds from a sale or other disposition of debt obligations producing US-source interest on or after 1 January 2019. However, proposed Treasury Regulations eliminate FATCA withholding on payments of gross proceeds entirely. Taxpayers generally may rely on these proposed Treasury Regulations until final Treasury Regulations are issued.

Deductions

Interest or original issue discount accruing on an obligation properly treated as debt for US federal income tax purposes will be deductible as interest or original issue discount accrues, subject to applicable limitations. All US corporations in the same affiliated group within the United States are generally able to consolidate returns for US federal income tax purposes.

The US tax reform at the end of 2017 enacted a new limitation on interest expense deductions for most businesses under which, in general, net interest deduction is limited to 30 per cent of 'adjusted taxable income' of the relevant taxpayer. For tax years beginning after 2021, 'adjusted taxable income' is largely similar to earnings before interest and taxes.

If a debt obligation is issued with a 'significant original issue discount' for US federal income tax purposes, matures more than five years after the issue date and its yield exceeds certain thresholds, the debt would be treated as an 'applicable high-yield debt obligation', in which case the original issue discount may not be deducted until paid and the deduction of a portion of the original issue discount on the debt may be permanently disallowed. These limitations can be avoided if the debt obligation provides for adequate partial prepayments after the fifth year (AHYDO catch-up payments).

There could be other limitations on deductions if the lender is related to the borrower, or if the debt obligation is convertible or payable in equity flavoured instruments.

Credit support

Historically, non-US affiliates that are treated as controlled foreign corporations for US federal income tax purposes have not provided guarantees to support the debt obligations of a US borrower, because such a guarantee would result in a deemed dividend to its direct or indirect US shareholders. In addition, to avoid a deemed dividend, no assets of a controlled foreign corporation must be pledged to support the debt obligations of a US borrower related to the controlled foreign corporation, and only up to two-thirds of the voting stock of a first-tier controlled foreign corporation should be pledged in support of such debt obligations. A controlled foreign corporation generally means a foreign corporation that is directly or indirectly or by attribution owned, in the aggregate, by more than 50 per cent (based on vote or value) by US shareholders. A US shareholder in this context generally

means a shareholder that is a US person and owns at least 10 per cent of the foreign corporation (by vote or value).

The US tax reform at the end of 2017 and subsequent guidance issued by the Treasury, however, opened possibilities for obtaining credit support from a controlled foreign corporation without causing material adverse tax consequences arising from a deemed dividend (discussed above). More specifically, Treasury Regulations issued in May 2019 effectively turned off the deemed dividend rule in respect of earnings of a foreign subsidiary that is a controlled foreign corporation (CFC) when the foreign subsidiary guarantees or provides certain pledges in support of debt of a related US borrower to the extent any deemed dividend could have qualified for deductions foreign-source dividends allowed under the US tax reform. Such deductions may generally be allowed provided that the following conditions are met:

1. the US corporate borrower (or its US corporate affiliate that owns the relevant foreign subsidiary) satisfies a one-year holding period requirement (and this requirement may be satisfied retrospectively, by continuing to own the CFC after the date of the deemed dividend);
2. the dividend is not a 'hybrid dividend' (generally, a dividend for which the foreign subsidiary would receive a deduction or other tax benefit with respect to taxes imposed by a foreign country had the foreign subsidiary paid an actual dividend); and
3. the dividend is foreign source (generally meaning the foreign subsidiary does not own a US business or US assets).

Security and guarantees

i Guarantees

Guarantees of obligations are typically provided by all material wholly owned domestic subsidiaries and the direct parent (if any) of the borrower. Depending on the business deal, non-wholly owned subsidiaries may also serve as guarantors, though that is less common. While there are corporate limitations on the value of guarantees by subsidiaries of the obligations of their parent entities, these limitations do not typically affect the taking of guarantees, only potentially the value thereof in an enforcement or bankruptcy proceeding. Nevertheless, particularly in the case of non-wholly owned subsidiaries, the organisational documents of guarantors should be reviewed to ensure that any guarantees are within the capacity of the guarantor. In the case of a guarantee that is required by the principal obligation and is being issued contemporaneously with the principal obligation, separate consideration to the guarantor is not required under New York law nor the law of many other states, although laws may vary among the states. Where the guarantee is not contemporaneous with the principal obligation, New York law provides that such guarantee is enforceable as long as any consideration is recited in the guarantee and proven to have been given, and would be valid consideration except for at the time that it was given.[2] The Restatement of the Law (Third), Suretyship and Guaranty takes a similar position, but not

all states follow this approach and in some states separate consideration may be required for a guarantee, particularly one executed after the primary obligation. For example, Section 2792 of the California Civil Code provides that:

> Where a suretyship obligation is entered into at the same time with the original obligation, or with the acceptance of the latter by the creditor, and forms with that obligation a part of the consideration to him, no other consideration need exist. In all other cases there must be a consideration distinct from that of the original obligation.

In addition, as noted above, except in limited circumstances, because of the potential adverse tax consequences arising under the US Tax Code, subsidiaries organised outside of the United States generally do not provide guarantees of obligations of a US borrower.

Whether the guarantee is immediately enforceable would depend on the terms of the guarantee. A guarantee of collection (which is uncommon) would generally require the holder of the guaranteed obligation to first exhaust its remedies against the principal obligor prior to seeking payment from the guarantor (unless the principal obligor is insolvent or the subject of an insolvency proceeding). In contrast, guarantees of payment, which are much more typical, do not require the holder of the guaranteed obligation to pursue its remedies against the principal obligor prior to seeking to enforce the guarantee. If the secured obligations include hedging obligations, the guarantor must qualify as an 'eligible contract participant' (ECP) to guarantee the hedging obligations. An ECP includes, among other things, a corporation, partnership or other entity that:

1. has total assets exceeding US$10 million; or
2. has a net worth exceeding US$1 million and enters into a swap in connection with the conduct of the entity's business or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the entity in the conduct of the entity's business.

Typically, both the guarantee and the security agreement will exclude any swap obligations of any person that is not an ECP.

ii Security

Security interests are most commonly taken over substantially all assets (other than real property) in a single security agreement. These assets may include general intangibles, including contract rights and intellectual property, accounts receivable, goods, including equipment, movable assets and inventory, securities and securities accounts and cash deposits. The single security agreement is typically under the law of the state that governs the loan agreement, although the assets intended to be covered by the security agreement may be located outside of the state. Such security interests can, and typically do, also extend to after-acquired assets. Interests in real property, whether owned or leased, need to be addressed in separate mortgage agreements enforceable under the state in which such real property is located. Regardless of the type of security interest, the scope of the secured claim or guaranteed obligation can be a single claim, or a multitude of present or future claims, or both. To specify future secured claims or guaranteed obligations, a general description would suffice provided that these claims are reasonably identified and

determinable. The perfection method for each type of these security interests is discussed in more detail below. It is essential to bear in mind that certain transactions, collateral and grantors are excluded from the Uniform Commercial Code (UCC) either in whole or in part. For example, in most cases, perfection of a security interest in titled motor vehicles will require compliance with the applicable state motor vehicles laws. With respect to motor vehicles titled in New York, a lien may be noted on the title by filing the appropriate documents with the Commissioner of the New York State Department of Motor Vehicles.

iii Creation and perfection

To create a valid security interest in those categories of collateral governed by the UCC, a grantor must execute or authenticate a written or electronic security agreement that provides an adequate description of the collateral. The grantor must have rights in the collateral or the power to transfer such rights, and value must be given. A security interest in most types of collateral governed by the UCC may generally be perfected by the filing of a notice filing under the UCC, referred to as a UCC financing statement. Although, as described below, certain assets may require actions beyond the filing of a financing statement, in many large transactions borrowers are able to limit the lender's ability to perfect the security to the filing of UCC financing statements, domestic intellectual property filings and the possession of certain equity interests and perhaps large dollar instruments.

iv Receivables

In addition to the general rules set forth above, if the receivable is evidenced by an instrument or chattel paper (a receivable secured by a specific good, such as a loan secured by a particular automobile, or a lease of specific goods, such as a lease of an automobile), perfection by possession or control of the instrument or chattel paper is preferable to perfection by a UCC financing statement as possession or control may entitle the secured party to higher priority and protect the secured party from third parties acquiring better rights in the collateral. Possession means physical possession of the original instrument or tangible written chattel paper by the secured party or an agent of the secured party (the grantor cannot be the agent of the secured party for purposes of perfection by possession). In the case of a chattel paper that exists solely in electronic form, an electronic equivalent of possession known as 'control' is legally possible; however, the rules are complex and counsel should be consulted if this method of perfection is desired. As noted earlier, if the underlying obligor is a federal, state or local governmental entity, compliance with various special laws applicable to these obligors may be necessary or advisable. Recent revisions to the UCC discussed below, which are currently in effect in a handful of states and pending in many others, also permit the creation of controllable accounts and controllable payment intangibles, which may be perfected by control.

v Movable assets and inventory

Consistent with the general rule, a security interest in inventory and equipment is generally perfected by the filing of a UCC financing statement. For most US corporations, limited liability companies and limited partnerships, the UCC financing statement would be filed in the jurisdiction in which that entity was formed, although there are exceptions for certain entities and collateral.

vi Securities and securities accounts

Unlike most other collateral, an oral security agreement with respect to securities and securities accounts can be sufficient in certain circumstances; however, such agreements are exceedingly rare, and a written or electronic security agreement is customary and advisable. The UCC provides separate perfection rules for each of the three methods by which a grantor may hold securities. A grantor may hold securities in the form of certificated securities issued directly to the grantor by the issuer of the security. This is a common way for a parent corporation to hold shares in a subsidiary corporation. Perfection of a security interest in a certificated security can be accomplished by either the filing of a UCC financing statement or by the secured party taking physical possession of the original share certificate either directly or through an agent of the secured party (the grantor cannot be the agent of the secured party for purposes of perfection by possession). Perfection by possession of the share certificate is preferable to perfection by a UCC financing statement as possession entitles the secured party to higher priority, and may protect the secured party from third parties acquiring better rights in the collateral. Although an endorsement is not required for perfection, there can be additional priority advantages from obtaining an endorsement, and the endorsement can help facilitate any disposition of the security upon foreclosure. It is customary for the share certificate to be delivered to the secured party accompanied by a stock transfer power duly executed in blank.

Another method of holding securities is in the form of uncertificated interests registered directly on the books and records of the issuer of the security or a transfer agent on behalf of the issuer. Perfection of a security interest in uncertificated securities can be accomplished by either the filing of a UCC financing statement or by the secured party obtaining control thereof. Control can be achieved by the secured party entering into an agreement with the issuer whereby the issuer agrees that it will comply with the instructions originated by the secured party directing the transfer or redemption of the security without further consent by the grantor. Control can also be achieved by the secured party becoming the registered owner of the uncertificated securities, although that is less common. Perfection by control is preferable to perfection by a UCC financing statement as control entitles the secured party to higher priority than a secured party that is perfected solely by the filing of a UCC financing statement, and may protect the secured party from third parties acquiring better rights in the collateral.

The final method of holding securities is through a securities account maintained by a financial institution referred to as a securities intermediary. This is the most common method of holding investment securities (whether debt or equity). The interest of the grantor in the securities maintained in a securities account is referred to as a security entitlement. Perfection of a security interest in these security entitlements can be accomplished by either the filing of a UCC financing statement or by the secured party obtaining control thereof. Control can be accomplished by the secured party entering into an agreement, commonly referred to as a securities account control agreement, with the securities intermediary whereby the securities intermediary agrees that it will comply with the instructions originated by the secured party directing the transfer or redemption of the underlying security without further consent by the grantor. Control can also be achieved by the secured party becoming the owner of the security entitlement on the books and records of the securities intermediary. As with other methods of holding securities described above,

perfection by control is preferable to perfection by a UCC financing statement, as control entitles the secured party to higher priority and may protect the secured party from third parties acquiring better rights in the collateral. The United States is a party to the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary (the Hague Convention). The Hague Convention contains choice of law rules applicable to the law governing, among other things, perfection of a security interest in securities held in a securities account, and contains limitations on the parties' ability to select the law governing security interest. If the relevant securities intermediary does not maintain a qualifying office in the United States, the choice of US law or the law of a US state will not be respected.

Many US companies are not organised as corporations, but rather as limited liability companies or limited partnerships. Interests in most limited liability companies and limited partnerships would not be classified as securities under the UCC unless the issuer makes a voluntary election to so treat the membership interests or partnership interests, or the interests are publicly traded. If the interests are not securities and are not credited to a securities account, they will be 'general intangibles', which can only be perfected by the filing of an appropriate UCC financing statement.

vii Cash deposits

Except as proceeds of other collateral, a security interest in deposit accounts can only be perfected by control, and the filing of a financing statement under the UCC would not perfect such security interest.

If the deposit bank that establishes and maintains the deposit account is the same legal entity as the secured party, then the secured party is deemed to be in control of the deposit account and thus perfected automatically. Historically, there has been a question as to whether this automatic perfection was available where the secured party is acting in a representative capacity (e.g., as an agent for its affiliates or a group of lenders). Recent amendments to the official comments of the UCC support the proposition that automatic perfection should be available even where the secured party is acting in a representative capacity. However, even in these cases, it is common for there to also be a deposit account control agreement both as 'belts and suspenders', and also because a deposit account control agreement has other provisions beyond mere control that may be helpful (clear choice of law rules, rules on set-off and so on).

In addition to automatic perfection, there are two other methods of control. The more common method for most types of financing transactions would be control by agreement, commonly referred to as a deposit account control agreement, whereby the debtor, the secured party and the deposit bank enter into a written agreement pursuant to which the deposit bank agrees to comply with all instructions issued by the secured party directing disposition of funds in the deposit account without further consent of the debtor.

The final method of control would be by the secured party becoming the deposit bank's customer with respect to the deposit account. This method is not commonly used for operating accounts, but it is more common for special accounts that the borrower is not intended to have access to, such as an account cash collateralising a letter of credit.

viii Intellectual property

A security interest in US-registered copyrights may be perfected solely by filing a copyright mortgage or copyright security agreement with the US Copyright Office. For patents and trademarks, these are likely perfected by the UCC financing statement. However, it is nonetheless customary to file a short-form security agreement with the US Patent and Trademark Office. This is both because of some lingering uncertainty as to the extent to which the UCC may be pre-empted by federal law in such circumstance, and because these filings may help protect against a buyer of the patent or trademark taking free of the security interest.

ix Controllable electronic records

A new Article 12 to the UCC and conforming amendments to the other articles of the UCC has now been enacted in a handful of states and is pending in many others. These revisions create new methods of perfection for many digital assets that are in the form of controllable electronic records, such as cryptocurrencies and NFTs, as well as controllable accounts and controllable payment intangibles. 'Controllable electronic record' means a record stored in an electronic medium that can be subject to control under Section 12-105. While the control rules are too complex for detailed discussion here, in general a secured party must have the power to avail itself of substantially all the benefits of the electronic record and, subject to certain exceptions, the exclusive power to prevent others from availing themselves of such benefits, as well as the power to transfer control of the record to another person.

x Enforcement

Security interests are immediately enforceable upon the occurrence of an enforcement event, subject to any automatic stay if the grantor is subject to a bankruptcy proceeding. Although a secured party has the option of seeking judicial enforcement of its security interest, there are a variety of 'self-help' remedies available under the UCC without the necessity of judicial action, and self-help would be much more common than resorting to judicial remedies. Any enforcement action by a secured party must be done without a breach of the peace, and any sale of collateral by the secured party must be commercially reasonable. Various notices are required in connection with any enforcement action. In addition, if the security interest at issue is securities or securities accounts, or both, it is advisable to review the organisational documents of the issuer of the securities as well as the applicable corporate or other law pursuant to which the issuer of the pledged securities was organised to determine whether there are any prohibitions, restrictions or consent requirements applicable to the creation of the security interest or the exercise of remedies by the secured party. Enforcement of security interests are, more often than not, accomplished in connection with a proceeding under the US Bankruptcy Code.

xi Bankruptcy and preference concerns

In the event of an insolvency proceeding over a guarantor or the grantor of a security interest, treatment of the guarantees and security interests will depend on various considerations. Importantly, if the security interest is not properly perfected, it will be set

aside. Even if the security interest is properly perfected, guarantees and security may be subject to avoidance by the bankruptcy trustee on a number of theories.

Upstream and cross-stream credit support consist of guarantees and security created by a subsidiary to support the obligations of its parent company or of an affiliate controlled by the common parent company. Both upstream and cross-stream credit support are common in the market and, subject to any restrictions in the organisational documents or under the law under which the entity was formed, such guarantees and security interests are permissible. Despite their widespread use, upstream and cross-stream credit support are subject to certain potential vulnerabilities. The biggest potential vulnerability is that these guarantees or security interests may be invalidated under federal or state fraudulent conveyance laws. Under the fraudulent conveyance provisions of the Bankruptcy Code and similar state fraudulent conveyance laws, even absent fraudulent intent, an upstream or cross-stream guaranty, as well as any security interest securing such guaranty, may be voidable as a fraudulent transfer if the provider of the guarantee or security interest receives less than 'reasonably equivalent value' in exchange for taking on the credit support obligations and the provider was insolvent at that time or as a result of the transfer (the incurrence of an obligation, including subsequent extensions of credit, is treated as a transfer); was engaged in a business for which it had unreasonably small capital; or intended to incur or believed it would incur debts beyond its ability to repay. Certain transfers made or obligations incurred with actual intent to hinder, delay or defraud creditors may be avoided regardless of whether the transferor received reasonably equivalent value or fair consideration for the transfer or obligation. Additionally, New York and other state laws contain fraudulent conveyance provisions that are very similar to those under the Bankruptcy Code. While federal fraudulent conveyance law covers transactions that occurred up to two years prior to the date on which the bankruptcy case was commenced, if state law is applicable many states have a six-year look-back period.

Significant risks to be aware of are the facts that could cause the security interest to be viewed as a preference. In general, a security interest that is granted in respect of antecedent debt (that is, debt that precedes the creation of the security interest) or that is granted substantially simultaneously with the incurrence of the debt being secured, but not perfected within 30 days of the creation of the security interest, would be at risk of being set aside as a preference if, in either case, the grantor filed for bankruptcy within 90 days of the security interest becoming perfected (or one year if the beneficiary of the security interest is an 'insider' of the grantor). If the security interest in question is granted substantially contemporaneous with the incurrence of the debt being secured and is perfected within 30 days of its creation, it is generally exempt from attack as a preference.

Priority of claims

i Priority generally

Assuming that the security interest is properly perfected and is not avoided (e.g., as a preference), the secured party will be entitled to receive the value of its interest in the collateral up to the amount of its secured obligations. The value of a secured party's interest in its collateral is generally the value of the collateral less the amount of any obligations

secured by a security interest or lien that is senior in priority under applicable state law. All properly perfected secured claims would be paid (up to the value of the collateral securing such claims) prior to the payment of any unsecured claims or claims secured by a security interest that is junior in priority either under applicable law or by contract. In addition, various administrative and other claims given priority by law would be satisfied prior to the payment of any unsecured claims. No parties (including governmental agencies and employees) are given any automatic statutory priority over secured creditors as a result of the US Bankruptcy Code. The status and priority of secured creditors are determined almost exclusively by reference to applicable non-insolvency law, and the Bankruptcy Code generally does not affect status and priority. Under the Bankruptcy Code, the bankruptcy court may grant a security interest with priority over all other security interests to a lender providing new financing to the borrower; however, such security interests may only be granted if either the lenders being primed by the new security interest consent, or if the bankruptcy court decides that the terms of the transaction provide the lenders being primed with adequate protection – a judicial determination that the recovery of the lenders being primed on the secured claims should not be negatively affected by the new financing and security interest.

ii Equitable subordination

Equitable subordination is generally not an issue except under specific fact patterns. These facts usually include a lender with an equity or other position that allows the lender to exercise some level of control over the borrower, with the borrower using the position to the detriment of other creditors. The facts supporting equitable subordination can also include other inequitable conducts that the bankruptcy court determines are sufficiently extreme and have caused damage to the borrower sufficient to warrant an equitable remedy; for example, where a competitor of the borrower acquires the loan and then deliberately obstructs the reorganisation process in the hopes of forcing the borrower to liquidate.

iii Treatment of intercreditor or subordination agreements

Section 510(a) of the Bankruptcy Code specifically provides for the enforceability of 'subordination agreements' during a bankruptcy case. Thus, intercreditor and subordination agreements are generally enforceable in bankruptcy to the same extent that they are enforceable under state law. A bankruptcy court will generally enforce the parties' agreement as to the priority of their respective claims (whether secured or unsecured). A bankruptcy court will also enforce many (although not all) of the waivers of rights under the Bankruptcy Code that junior secured parties typically agree to in second-lien transactions.

Jurisdiction

The United States is a multi-jurisdictional country, and the loan agreement needs to select the law of a particular US state (rather than federal law) as the governing law. The choice by the contractual parties of a particular state's law to govern a contract may not be given effect if it does not bear a reasonable relationship with the transaction or parties. A few states, such as New York, permit the choice of their law to govern a contract even in the absence of any contacts if the contract satisfies certain dollar thresholds; however, another

US state may not respect this choice of law if litigated in the other US state in the absence of a reasonable relationship.

Each state has somewhat different considerations in determining whether to give effect to a choice of law (other than the law of the applicable state). Typically, a choice of law will be given effect if:

1. the chosen law has a reasonable and substantial relationship and sufficient contacts with the underlying agreement, or the transaction contemplated thereby, and the chosen law has the most significant contacts with the matter in dispute;
2. application of the chosen law does not violate or contravene, nor is contrary or offensive to, a public or fundamental policy of the state or of another jurisdiction whose law would apply in the absence of an effective choice of law by the parties to the underlying agreement (which may be another US state or a foreign jurisdiction);
3. the chosen law was not induced or procured by fraud; and
4. the matter of law for which the chosen law is to be applied has been previously addressed by the chosen law, and the chosen law differs from the law that would be applied in the absence of the chosen law.

Under the Restatement (Second) of Conflicts of Law, a court may decline to apply the law of a jurisdiction chosen by the parties to a contract (which may be another US state or a foreign jurisdiction) when it is necessary to protect the fundamental policies of the state, the law of which would otherwise apply; and the state has a materially greater interest in the determination of a particular issue than the state of the chosen law. Regardless of which state's law governs a security interest, the UCC contains mandatory choice of law rules for perfection that will frequently result in the law of a different state governing some or all of the perfection of any security interest.

Acquisitions of public companies

i Methods of acquisition

Acquisitions of public companies are generally accomplished through one of two methods. Either a consensual process by which the board of the target and the acquirer approve the acquisition and then solicit approval of the transaction by a majority vote of shareholders or through a direct tender offer for the shares followed by a squeeze-out merger of any remaining minority holdings (which may or may not be consensual at launch). While there are considerable federal regulatory requirements relating to public company takeovers as well as significant state laws that will affect the structuring of the acquisition, other than the margin regulations mentioned earlier, these rules are not directed at the financing. Acquisition financing typically has highly limited conditionality driven not by statute, but by both the competitive dynamics among potential bidders and the fiduciary duties of the board to approve the 'most certain' transaction.

ii Disclosure of financing terms

As part of the public disclosure required for the solicitation of votes on a merger agreement or the solicitation of shares pursuant to the tender offer, generic sources and uses, which would include fees, must be provided; however, market flex terms generally do not need to be disclosed. To the extent the borrower or the target have publicly traded securities, the securities rules that apply to material non-public information (MNPI) apply, and syndication processes are generally structured to allow lenders who do not wish to receive MNPI to have access only to materials that do not contain MNPI.

iii Margin regulations

Financing of acquisitions of public companies, including take-private transactions, can often raise issues under the US margin regulations discussed above. Even in the absence of a pledge of publicly traded securities, certain transaction structures can create indirect security over such securities. The existence of indirect security can trigger the margin regulation restrictions on the amount of credit that can be extended, either as loans or debt securities.

Outlook and conclusions

The syndicated loan market in 2023 has been less robust than prior years, as has the direct loan market (although to a lesser degree), as the pace of acquisitions has slowed and the market outlook remains uncertain. Pricing continues to be more variable based on the credit quality of the borrower and other market conditions, and there is some tightening of the covenant packages for all borrowers. In particular, certain restructuring transactions over the past few years (including those commonly referred to as *JCrew, PetSmart* and *Serta*) have utilised the basket capacity and voting provisions of various financing agreements in a manner both adverse and unexpected by a material portion of the market participants. These transactions have caused a renewed focus on the provisions that enabled them.

Endnotes

1 Melissa Alwang, David Hammerman, Jiyeon Lee-Lim and Lawrence Safran are partners and Pia Naib is a counsel at Latham & Watkins LLP. ^ Back to section

2 Section 5-1105 of the New York General Obligations Law. ^ Back to section

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