The Acquisition and Leveraged Finance Review

Eighth Edition

Editor

Fernando Colomina Nebreda

The LawReviews

THE ACQUISITION AND LEVERAGED FINANCE REVIEW

EIGHTH EDITION

Editor
Fernando Colomina Nebreda

THE LAWREVIEWS

PUBLISHER
Clare Bolton

HEAD OF BUSINESS DEVELOPMENT
Nick Barette

TEAM LEADERS
Joel Woods, Jack Bagnall

BUSINESS DEVELOPMENT MANAGERS
Rebecca Mogridge, Katie Hodgetts, Joey Kwok

RESEARCH LEAD
Kieran Hansen

EDITORIAL COORDINATOR
Georgia Goldberg

PRODUCTION AND OPERATIONS DIRECTOR
Adam Myers

PRODUCTION EDITOR
Anna Andreoli

SUBEDITOR
Ronan Gerrard

CHIEF EXECUTIVE OFFICER
Nick Brailey

Published in the United Kingdom
by Law Business Research Ltd, London
Meridian House, 34–35 Farringdon Street, London, EC4A 4HL, UK

www.TheLawReviews.co.uk

ISBN 978-1-83862-755-3

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

ACKNOWLEDGEMENTS

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

ANDERSON MŌRI & TOMOTSUNE

ADVOKATFIRMAET BAHR AS

AKSU ÇALIŞKAN BEYGO ATTORNEY PARTNERSHIP (ASC LAW)

ANJIE LAW FIRM

BECCAR VARELA

GILBERT + TOBIN

GOODMANS LLP

HEUSSEN

LATHAM & WATKINS

LEE AND LI, ATTORNEYS-AT-LAW

MILBANK LLP

NASSIRY LAW INC

PINHEIRO NETO ADVOGADOS

SCHOENHERR (IN COOPERATION WITH LAW FIRM STOYANOV AND TSEKOVA)

WALDER WYSS LTD

CONTENTS

PREFACE

It is fair to say that the acquisition and leveraged finance industry has shown resilience in relation to the difficult global situation arising from the covid-19 pandemic, particularly in comparison to the previous global crisis in 2008. Generally speaking, while in the first semester of 2020 the deal flow slowed as a result of covid-19 as private equity (PE) houses were forced to shift their focus onto already existing portfolios, there was a noteworthy increase in the acquisition and leveraged market activity in the second semester, predominantly in the last quarter. The following defensive industries have demonstrated their ability to withstand the covid-19 crisis: pharmceuticals; bio sanitary; food; technology, media and telecommunications; and logistics, among others.

Covid-19 vaccines are providing confidence to market players, therefore facilitating the ability to agree on valuations, and also reducing gaps between the expectations of both seller and buyer. The result is more mergers and acquisitions (M&A) activity. Besides, it is reasonable to expect that the emergency measures taken by governments worldwide to address the hardships caused by covid-19 (such as state aid measures or public restrictions regarding foreign direct investment) will gradually be removed. This should, in principle, also lead to more deal flow in the M&A sector.

We are currently witnessing fierce competition in the acquisition and leveraged finance market due to the following factors: (1) an abundance of liquidity (perhaps even more than the previous year since some PE houses now hold additional 'dry powder' that was allocated to 2020 but which they could not use because of covid-19); (2) a low-interest-rate environment, which is likely to persist for several years; and (3) the fact that US investors are increasingly entering EU markets seeking a higher yield and vice versa.

The above is, in turn, resulting in more flexible terms for sponsors. It is also helping to consolidate the trend on convergence between both high-yield structures and loan structures and US and European markets in the world's most sophisticated financial hubs. Once again, this means that careful and thoughtful monitoring of domestic circumstances is imperative.

Finally, as indicated by the European Leveraged Finance Association, it is worth remarking that 'the leveraged finance market is undergoing a seismic shift in approach to ESG [environmental, social and governance] and sustainability'. Indeed, ESG has emerged dramatically in the acquisition and leveraged finance industry as evidenced by the blossoming of loans and bonds linked to sustainability in 2021. Terms will continue to unfold as market players intend to develop broadly ESG terms that go beyond pricing considerations. To this end, transparency will be a key factor in the success of the cross-border expansion tied to this nascent trend.

Many thanks to everybody who has participated in this publication, and a special thank you to Law Business Research.

We sincerely hope that this edition of *The Acquisition and Leveraged Finance Review* will be of assistance to you in this challenging era.

Fernando Colomina Nebreda
Latham & Watkins
Madrid
November 2021

Chapter 16

UNITED STATES

Melissa Alwang, Alan Avery, David Hammerman, Jiyeon Lee-Lim and Lawrence Safran[1]

I OVERVIEW

Leveraged acquisitions are typically financed through a mixture of high-yield bonds and term loans, with ongoing working capital requirements provided through cash flow or asset-backed revolving facilities entered into concurrently with the acquisition. Financings utilising term loans and revolving facilities are typically guaranteed by each material 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 2020 was at a 10-year low, with US$1.54 trillion of syndicated loans issued, a 27 per cent decline compared to 2019's US$2.12 trillion.

II REGULATORY AND TAX MATTERS

i Regulatory issues

Regulatory concerns for debt finance in the leveraged acquisition context typically arise under regulations related to authorisation and sanctions. 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, so these restrictions are generally not a concern for specific syndicate members.

1 Melissa Alwang, Alan Avery, David Hammerman, Jiyeon Lee-Lim and Lawrence Safran are partners at Latham & Watkins LLP.

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 US, or 'margin stock', then the loan may be subject to additional restrictions. Such restrictions, often referred to as the 'margin regulations', limit the amount of loans that can be collateralised by such securities. The US margin regulations can also be implicated by the existence of arrangements that constitute indirect security over margin stock, such as through negative pledge provisions or other arrangements that limit a borrower's right to sell, pledge or otherwise dispose of margin stock.

Government receivables

With respect to collateral consisting of receivables, if the debtor under such receivable is the US government or one of its agencies or instrumentalities, the Federal Assignment of Claims Act will apply to an assignment of receivables and the right of the federal government to exercise set-off. A minority of states have similar laws that apply to obligations of the state or agencies or departments thereof, and a few states extend such rules to municipalities and other local governmental entities.

Regulatory developments – leverage lending guidance

In March 2013, the three US federal banking agencies, 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. This 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. While the status of the Leveraged Lending Guidance is currently unclear due to a determination by the Government Accountability Office that the guidance is a 'rule' that is subject to review by the US Congress under the Congressional Review Act, 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 regulators 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 US). 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:

a the debt obligation must be in 'registered form' for US federal income tax purposes;
b 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
c 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 such lender's trade or business in the United States, such interest will not be subject to US federal withholding as long as such lender submits a properly completed IRS Form W-8ECI, but will generally be subject to net income tax in the United States and, for foreign corporations, branch profits taxes.

Additionally, withholding taxes may arise in other circumstances, including the payment of various fees (such as letter of credit fees), modifications to debt obligations, and certain adjustments to conversion ratio on debt obligations that are convertible into stock.

Foreign Account Tax Compliance Act (FATCA)

Under provisions commonly referred to as FATCA, a 30 per cent withholding tax may be imposed on interest on, and, subject to the proposed Treasury regulations discussed below, gross proceeds from the sale, redemption, retirement or other disposition of, a debt obligation of a United States 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 the foreign financial institution enters into an agreement with the IRS and undertakes certain investigation, reporting and other required obligations; the non-financial foreign entity either certifies it does not have any substantial United States owners or furnishes identifying information regarding each substantial United States owner; or the foreign financial institution or non-financial foreign entity otherwise qualifies for an exemption from these rules. Foreign financial institutions located in jurisdictions that have an intergovernmental agreement with the United States governing these rules may be subject to different rules. FATCA withholding tax generally applies to payments of US-source interest made on or after 1 July 2014, and to payments of gross proceeds from a sale or other disposition of debt obligations producing US-source interest on or after 1 January 2019. However, recently 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 such 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 before the end of 2021, 'adjusted taxable income' is largely similar to earnings before interest, taxes, depreciation and amortisation (EBITDA) and for taxable years beginning after 2021, it is largely similar to earnings before interest and taxes (EBIT).

Under the Coronavirus Aid, Relief, and Economic Security Act enacted in March of 2020, the 30 per cent general cap on net business interest deduction was increased to a 50 per cent cap for any taxable year beginning in 2019 and 2020. A taxpayer can also elect to use its adjusted taxable income for the 2019 taxable year in computing the limitation for 2020. Partnerships are subject to special rules.

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. Such 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 such deemed dividend, no assets of a controlled foreign corporation have been 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 would 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 United States shareholders. A United States shareholder in this context means a shareholder that is a United States person and owns at least 10 per cent of the foreign corporation.

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. 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:

a 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);

b 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

c the dividend is foreign source (generally meaning the foreign subsidiary does not own a US business or US assets).

III 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, such limitations do not typically affect the taking of such guarantees, only potentially the value thereof in an enforcement or bankruptcy proceeding. Nevertheless, particularly in the case of non-wholly owned subsidiaries, the organisational documents of guarantors should be reviewed to ensure that any guarantees are within the capacity of the guarantor. In the case of a guarantee that is required by the principal 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 (Third) of Suretyship & Guaranty takes a similar position, but not all states follow this approach and in some states separate consideration may be required for a guarantee, 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.*

2 Section 5-1105 of the New York General Obligations Law.

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 US 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 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 will include hedging obligations, the guarantor will need to qualify as an 'eligible contract participant' (ECP) in order to guarantee the hedging obligations. An ECP includes, inter alia, 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.

ii Security

Security interests are most commonly taken over substantially all assets (other than real property) in a single security agreement. Such assets may include general intangibles, including contract rights and intellectual property, accounts receivable, goods, including equipment, 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 such security agreement may be located outside of such state. Such security interests can, and typically do, also extend to after-acquired assets. Interests in real property, whether owned or leased, need to be addressed in separate mortgage agreements enforceable under the state in which such real property is located. Regardless of the type of security interest, the scope of the secured claim or guaranteed obligation can be a single claim; or a multitude of present or future claims, or both. To specify future secured claims or guaranteed obligations, a general description would suffice provided that these claims are reasonably identified and determinable. The perfection method for each type of these security interests is discussed in more detail below. It is essential to bear in mind that certain transactions, collateral and grantors are excluded from the Uniform Commercial Code (UCC) either in whole or in part. For example, in most cases, perfection of a security interest in titled motor vehicles will require compliance with the applicable state motor vehicles laws. With respect to motor vehicles titled in New York, a lien may be noted on the title by filing the appropriate documents with the Commissioner of the New York Department of Motor Vehicles.

iii Perfection and creation

To create a valid security interest in those categories of collateral governed by the UCC, a grantor must execute or authenticate a written or electronic security agreement that provides an adequate description of the collateral, the grantor must have rights in the collateral or the power to transfer such rights, and value must be given. A security interest in most types of collateral governed by the UCC may generally 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 certain 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 such obligors may be necessary or advisable.

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 certain collateral.

vi Securities and securities accounts

Unlike most other collateral, an oral security agreement with respect to securities and securities accounts can be sufficient in certain circumstances; however, such agreements are exceedingly rare, and a written or electronic security agreement is customary and advisable. The UCC provides separate perfection rules for each of the three methods by which a grantor may hold securities. A grantor may hold securities in the form of certificated securities issued directly to the grantor by the issuer of the security. This is a common way for a parent corporation to hold shares in a subsidiary corporation. Perfection of a security interest in a certificated security can be accomplished by either the filing of a UCC financing statement or by the secured party taking physical possession of the original share certificate either directly or through an agent of the secured party (the grantor cannot be the agent of the secured party for purposes of perfection by possession). Perfection by possession of the share certificate is preferable to perfection by a UCC financing statement as possession entitles the secured party to higher priority and may protect the secured party from third parties acquiring better rights in the collateral. Although an endorsement is not required for perfection, there can be additional priority advantages from obtaining an endorsement, and the endorsement can help facilitate any disposition of the security upon foreclosure thereof. It is customary for the share certificate to be delivered to the secured party accompanied by a stock transfer power duly executed in blank.

Another method of holding securities is in the form of uncertificated interests registered directly on the books and records of the issuer of the security or a transfer agent on behalf of the issuer. Perfection of a security interest in uncertificated securities can be accomplished by either the filing of a UCC financing statement or by the secured party obtaining control thereof. Control can be achieved by the secured party entering into an agreement with the issuer whereby the issuer agrees that it will comply with the instructions originated by the secured party directing the transfer or redemption of the security without further consent by the grantor. Control can also be achieved by the secured party becoming the registered owner of the uncertificated securities, although that is less common. Perfection by control is preferable to perfection by a UCC financing statement as control entitles the secured party to higher priority than a secured party that is perfected solely by the filing of a UCC financing statement, and may protect the secured party from third parties acquiring better rights in the collateral.

The final method of holding securities is through a securities account maintained by a financial institution referred to as a securities intermediary. This is the most common method of holding investment securities (whether debt or equity). The interest of the grantor in the securities maintained in a securities account is referred to as a security entitlement. Perfection of a security interest in these security entitlements can be accomplished by either the filing of a UCC financing statement or by the secured party obtaining control thereof. Control can be accomplished by the secured party entering into an agreement, commonly referred to as a securities account control agreement, with the securities intermediary whereby the securities intermediary agrees that it will comply with the instructions originated by the secured party directing the transfer or redemption of the underlying security without further consent by the grantor. Control can also be achieved by the secured party becoming the owner of the security entitlement on the books and records of the securities intermediary. As with the other methods of holding securities described above, perfection by control is preferable to perfection by a UCC financing statement as control entitles the secured party to higher priority and may protect the secured party from third parties acquiring better rights in the collateral. 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 such 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 thereof makes a voluntary election to so treat the membership interests or partnership interests or such interests are publicly traded. If the interests are not securities and are not credited to a securities account, they will be 'general intangibles', which can only be perfected by the filing of an appropriate UCC financing statement.

vii Cash deposits

Except as proceeds of other collateral, a security interest in deposit accounts can only be perfected by control, and the filing of a financing statement under the UCC would not perfect such security interest.

If the deposit bank that establishes and maintains the deposit account is the same legal entity as the secured party, then the secured party is deemed to be in control of the deposit account and thus perfected automatically. Historically, there has been a question as to whether this automatic perfection was available where the secured party is acting in a representative capacity (e.g., as an agent for its affiliates or a group of lenders). Recent amendments to the official comments 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 such cases, it is common for there to also be a deposit account control agreement both as 'belts and suspenders' and also because a deposit account control agreement has other provisions beyond mere control that may be helpful (clear choice of law rules, rules on set-off, etc.).

In addition to automatic perfection, there are two other methods of control. The more common method for most types of financing transactions would be control by agreement, commonly referred to as a deposit account control agreement, whereby the debtor, the secured party and the deposit bank enter into a written agreement pursuant to which the deposit bank agrees to comply with all instructions issued by the secured party directing disposition of funds in the deposit account without further consent of the debtor.

The final method of control would be by the secured party becoming the deposit bank's customer with respect to the deposit account. This method is not commonly used with respect to operating accounts, but is more common with respect to special accounts that the borrower is not intended to have access to, such as an account cash collateralising a letter of credit.

viii Intellectual property

A security interest in US-registered copyrights may be perfected solely by filing a copyright mortgage or copyright security agreement with the United States 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 also because such filings may help protect against a buyer of the patent or trademark taking free of the security interest.

ix Enforcement

Security interests are immediately enforceable upon the occurrence of an enforcement event, subject to any automatic stay in the event that the grantor is subject to a bankruptcy proceeding. Although a secured party has the option of seeking judicial enforcement of its security interest, there are a variety of 'self-help' remedies available under the UCC without the necessity of judicial action and self-help would be much more common than resorting to judicial remedies. Any enforcement action by a secured party must be done without any breach of the peace and must be commercially reasonable. Various notices are required in connection with any enforcement action. In addition, if the security interest at issue is securities or securities accounts, or both, it is advisable to review the organisational documents of the issuer of the securities as well as the applicable corporate or other law pursuant to which the issuer of the pledged securities was organised to determine whether there are any prohibitions, restrictions or consent requirements applicable to the creation of the security interest or the exercise of remedies by the secured party with respect thereto. Enforcement of security interests are, more often than not, accomplished in connection with a proceeding under the US Bankruptcy Code.

x Bankruptcy and preference concerns

In the event of an insolvency proceeding over a guarantor or the grantor of a security interest, treatment of the guarantees and security interests will depend on various considerations. Importantly, if the security interest is not properly perfected, then it will be set aside. Even if the security interest is properly perfected, guarantees and security may be subject to avoidance by the bankruptcy trustee on a number of theories.

Upstream and cross-stream credit support consist of guarantees and security created by a subsidiary to support the obligations of its parent company or of an affiliate controlled by the common parent company. Both upstream and cross-stream credit support are common in the market and, subject to any restrictions in the organisational documents or under the law under which the entity was formed, such guarantees and security interests are permissible. Despite their widespread use, upstream and cross-stream credit support are subject to certain potential vulnerabilities. The biggest potential vulnerability is that such guarantees or such security interests may be invalidated under federal or state fraudulent conveyance laws. Under the fraudulent conveyance provisions of the Bankruptcy Code and under similar state fraudulent conveyance laws, even absent fraudulent intent, an upstream or cross-stream guaranty, as well as any security interest securing such guaranty, may be voidable as a fraudulent transfer if the provider of such guarantee or security interest receives less than 'reasonably equivalent value' in exchange for taking on the credit support obligations and such provider was insolvent at that time or as a result of the transfer (the incurrence of an obligation, including subsequent extensions of credit, is treated as a transfer); was engaged in a business for which it had unreasonably small capital; or intended to incur or believed it would incur debts beyond its ability to repay. Certain transfers made or obligations incurred with actual intent to hinder, delay or defraud creditors may be avoided whether or not the transferor received reasonably equivalent value or fair consideration for the transfer or obligation. Additionally, New York 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.

One significant risk to be aware of are the facts that could cause the security interest to be viewed as a preference. In general, a security interest that is granted in respect of antecedent debt (that is, debt that precedes the creation of the security interest) or that is granted substantially simultaneously with the incurrence of the debt being secured but not perfected within 30 days of the creation of the security interest would be at risk of being set aside as a preference if, in either case, the grantor filed for bankruptcy within 90 days of the security interest becoming perfected (or one year if the beneficiary of the security interest is an 'insider' of the grantor). If the security interest in question is granted substantially contemporaneous with the incurrence of the debt being secured and is perfected within 30 days of its creation, then it is generally exempt from attack as a preference.

IV PRIORITY OF CLAIMS

i Priority generally

Assuming that the security interest is properly perfected and is not avoided (e.g., as a preference), then the secured party will be entitled to receive the value of its interest in the collateral up to the amount of its secured obligations. 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 such status and priority. Under the Bankruptcy Code, the bankruptcy court may grant a security interest with priority over all other security interests to a lender providing new financing to the borrower; however, such security interests may only be granted if either the lenders being primed by the new security interest consent, or if the bankruptcy court decides that the terms of the transaction provide the lenders being primed with adequate protection – a judicial determination that the recovery of the lenders being primed on the secured claims should not be negatively affected by the new financing and security interest.

ii Equitable subordination

Equitable subordination is generally not an issue except under specific fact patterns. Those 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 that position to the detriment of other creditors. The facts supporting equitable subordination can also include other inequitable conducts that the bankruptcy court determines are sufficiently extreme and have caused damage to the borrower sufficient to warrant an equitable remedy; for example, where a competitor of the borrower acquires the loan and then deliberately obstructs the reorganisation process in the hopes of forcing the borrower to liquidate.

iii Treatment of intercreditor or subordination agreements

Section 510(a) of the Bankruptcy Code specifically provides for the enforceability of 'subordination agreements' during a bankruptcy case. Thus, intercreditor and subordination agreements are generally enforceable in bankruptcy to the same extent that they are enforceable under state law. A bankruptcy court will generally enforce the parties' agreement as to the priority of their respective claims (whether secured or unsecured). A bankruptcy court will also enforce many (although not all) of the waivers of rights under the Bankruptcy Code that junior secured parties typically agree to in second-lien transactions.

V JURISDICTION

The US is a multi-jurisdictional country, and the loan agreement needs to select the law of a particular US state (rather than federal law) as the governing law. The choice by the contractual parties of a particular state's law to govern a contract may not be given effect if it does not bear a reasonable relationship with the transaction or parties. A few states, such as New York, permit the choice of their law to govern a contract even in the absence of any contacts if the contract satisfies certain dollar thresholds; however, another US state may not respect this choice of law if litigated in the other US state in the absence of a reasonable relationship.

Each state has somewhat different considerations in determining whether to give effect to a choice of law (other than the law of the applicable state). Typically, such a choice of law will be given effect if:

a the chosen law has a reasonable and substantial relationship and sufficient contacts with the underlying agreement or the transaction contemplated thereby, and the chosen law has the most significant contacts with the matter in dispute;

b application of the chosen law does not violate or contravene, nor is contrary or offensive to, a public or fundamental policy of the state or of such other jurisdiction whose law would apply in the absence of an effective choice of law by the parties to the underlying agreement (which may be another US state or a foreign jurisdiction);

c the chosen law was not induced or procured by fraud; and

d the matter of law for which the chosen law is to be applied has been previously addressed by the chosen law, and the chosen law differs from the law that would be applied in the absence of the chosen law.

Under the Restatement (Second) of Conflicts of Law, a court may decline to apply the law of a jurisdiction chosen by the parties to a contract (which may be another US state or a foreign jurisdiction) when it is necessary to protect the fundamental policies of the state, the law of which would otherwise apply; and such state has a materially greater interest in the determination of a particular issue than the state of the chosen law. 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.

VI 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, such 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 such 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 such indirect security can trigger the margin regulation restrictions on the amount of credit that can be extended, either as loans or debt securities.

VII OUTLOOK

The market continues to be robust, and although pricing has become more variable based on the credit quality of the borrower and other market conditions, the covenant packages for all borrowers continue to have a significant level of flexibility. However, certain restructuring transactions over the past few years (including those commonly referred to as JCrew, Petstmart 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. Such transactions have caused a renewed focus on the provisions that enabled such transactions.

Appendix 1

ABOUT THE AUTHORS

MELISSA ALWANG

Latham & Watkins LLP

Melissa Alwang is a partner in the New York office of Latham & Watkins and a member of the firm's finance department and the banking practice. Ms Alwang has decade-long experience representing clients in market leading transactions across a broad array of industries, such as industrials, technology, healthcare and consumer.

She primarily handles the representation of major financial institutions in leveraged finance transactions, including international financings, acquisition financings, debtor-in-possession and exit financings, margin loan financings and asset-based facilities. Ms Alwang handles a variety of transactions for institutions such as JP Morgan, Barclays, Credit Suisse, Citibank, Morgan Stanley, Goldman Sachs, Bank of America and Deutsche Bank. She is recommended by *Chambers USA*, *Chambers Global* and *The Legal 500*. Clients specifically praise her expertise in multi-jurisdictional deals and note her knowledge of the European and Asian markets. Ms Alwang is a member of the firm's auction intake and income partner/counsel review committees.

ALAN AVERY

Latham & Watkins LLP

Alan W Avery is a partner in the New York office of Latham & Watkins. Mr Avery is a member of the corporate department and the financial institutions group. He concentrates on federal and state regulation of banking organisations, advising domestic and foreign banking institutions concerning the impact of US federal and state banking laws on their global operations.

Additionally, he advises domestic and foreign banks on regulatory issues, including Bank Secrecy Act (BSA) and anti-money laundering issues and investigatory matters, as well as related corporate and litigation matters. Mr Avery also advises domestic and foreign financial institutions and other parties on a wide range of matters related to US financial regulatory reform.

DAVID HAMMERMAN

Latham & Watkins LLP

David Hammerman is a partner in the New York office of Latham & Watkins. Mr Hammerman is a member of the firm's restructuring and special situations practice, where he focuses on financial restructurings and Chapter 11 reorganisations. He represents various creditors, shareholders, purchasers and distressed companies in all facets of the restructuring and reorganisation process, including extensive work on out-of-court workouts. Mr Hammerman is a co-leader of the firm's bankruptcy opinion practice, a former member of the firm's training and career enhancement (TACE) committee, and a former member of the firm's recruiting and mentoring committees. Mr Hammerman is also an active participant in the firm's pro bono programme, representing Holocaust survivors in connection with various reparations programmes. Mr Hammerman has experience in a wide range of corporate and finance matters. He has represented clients in connection with public and private financing transactions, mergers and acquisitions, and numerous real estate financing transactions. He has been named a 'rising star' by the *New York Law Journal*.

JIYEON LEE-LIM

Latham & Watkins LLP

Jiyeon Lee-Lim currently serves as the firm's global chair of the tax department. Ms Lee-Lim is on the executive committee of the tax section of the New York State Bar Association (NYSBA) and is a co-chair of the NYSBA tax section committee on cross-border capital markets. She is a member of the Tax Forum. Ms Lee-Lim previously served as the global chair of the firm's international tax practice, and is ranked by *Chambers Global*, *Chambers USA* and *The Legal 500: US* as a notable practitioner. She has been named in 'tax authority's influential women in tax law' by *Law360*.

LAWRENCE SAFRAN

Latham & Watkins LLP

Lawrence Safran is a partner in the New York office of Latham & Watkins. Mr Safran is a member of the firm's finance department and the aircraft finance, banking, project finance and structured finance and securitisation practices. This area includes a wide variety of commercial law issues. Special emphasis is placed on those issues arising under Article 9 (secured transactions) and Article 8 (investment securities) of the Uniform Commercial Code, although the practice also includes Article 2 (sales of goods), Article 3 (negotiable instruments), Article 5 (letters of credit), Article 6 (bulk sales) and Article 7 (documents of title). Mr Safran advises clients on commercial law and personal property transfer issues in connection with credit facilities, second lien bond transactions, project financings, real estate securitisations, collateralised debt obligations, credit card and other receivables financings and other structured financing arrangements.

LATHAM & WATKINS

Latham & Watkins LLP
1271 Avenue of the Americas
New York, NY 10022
United States
Tel: +1 212 906 1200
melissa.alwang@lw.com
alan.avery@lw.com
david.hammerman@lw.com
jiyeon.lee-lim@lw.com
larry.safran@lw.com
www.lw.com

an LBR business

ISBN 978-1-83862-755-3