IN-DEPTH

Acquisition And Leveraged Finance

EDITION 10

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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.

Generated: January 22, 2024

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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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November 2023

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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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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 headline contributor 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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