The Acquisition and Leveraged Finance Review

Fourth Edition

Editor
Christopher Kandel

The LawReviews

THE ACQUISITION AND LEVERAGED FINANCE REVIEW

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PREFACE

Acquisition and leveraged finance is a fascinating area for lawyers, both inherently and because of its potential for complexity arising out of the requirements of the acquisition process, cross-border issues, regulation and the like. It can also cut across legal disciplines, at times requiring the specialised expertise of merger and acquisition lawyers, bank finance lawyers, securities lawyers, tax lawyers, property lawyers, pension lawyers, intellectual property lawyers and environmental lawyers, among others. An additional area of complexity and interest at the moment comes out of market forces that are driving convergence in the large cap leveraged financings between loan and high-yield bond products generally, as well as between different markets (particularly pressure on markets outside the United States to conform to terms available in the US market but sometimes also vice versa), and increasingly the market is debating whether to adjust for differences in bankruptcy, guarantee or security regimes, and frequently deciding not to.

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

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

Christopher Kandel
Latham & Watkins LLP
London
August 2017

Chapter 22

UNITED STATES

Melissa Alwang, Alan Avery, Mark Broude, Jiyeon Lee-Lim and Lawrence Safran[1]

I OVERVIEW

Leveraged acquisitions are typically financed through a mixture of high-yield bonds and term loans, with ongoing working capital requirements provided through cash flow or asset-backed revolving facilities entered into concurrently with the acquisition. Financings utilising term loans and revolving facilities are typically guaranteed by each material subsidiary of the borrower and secured by substantially all the assets of the borrower and each guarantor, and second-lien structures are common. High-yield bond financings are more likely to be unsecured, but are sometimes secured on a first or second lien basis. The sources of funding are broad, including collateralised loan obligations and other institutional lenders, retail loan funds and commercial banks. Recent leveraged lending activity has been very strong, with approximately US$2 trillion in syndicated loans issued in 2016.

II REGULATORY AND TAX MATTERS

i Regulatory issues

Regulatory concerns for debt finance in the leveraged acquisition context typically arise under regulations related to authorisation and sanctions. In addition, certain types of collateral may be subject to special regulations. 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 generally does not subject the lender to licensing or other qualification requirements to do business in the United States, although there may be exceptions to this rule from state to state. Collection and enforcement activities are more likely to require an entity to obtain a licence and qualify to do business within a state. However, in almost all leveraged acquisition financing, only the administrative agent (or collateral agent) will be acting in the capacity of the collecting or enforcing bank, so these restrictions are generally not a concern for specific syndicate members.

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

Sanctions

Federal sanctions and anti-money laundering laws require financial institutions to implement due diligence procedures with respect to their customers in order to prevent the transfer of cash to certain prohibited countries and persons.

Collateral-related regulations

Margin loans

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

Government receivables

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

Regulatory developments – leverage lending guidance

In March 2013, the three US federal banking agencies jointly issued updated supervisory guidance for financial institutions engaged in leveraged lending activities, including acquisition financing. The guidance sets forth enhanced expectations in a number of areas and cautions banks to strengthen their risk management of loans to highly leveraged borrowers. These regulatory developments have curtailed the regulated entities ability to commit to certain highly leveraged transactions.

ii Tax issues

Withholding taxes

The United States generally imposes a 30 per cent federal withholding tax on interest paid to a non-US lender on a debt obligation of a US person (and certain non-US persons engaged in a trade or business in the US). This withholding tax may be eliminated (or reduced to a lesser amount) pursuant to an applicable income tax treaty between the United States and the country in which a lender receiving interest is resident.

Alternatively, a non-US lender may qualify for an exemption from US federal withholding on interest under the 'portfolio interest exemption'. To qualify for the portfolio interest exemption, the debt obligation must be in 'registered form' for US federal income tax purposes; the lender must not be a controlled foreign corporation related to the borrower or a bank receiving interest on an extension of credit entered into in the ordinary course of its trade or business; and the lender must not own, directly, indirectly or by attribution, equity representing 10 per cent or more of the total combined voting power of all voting stock of the borrower (or, if the borrower is a partnership, 10 per cent or more of capital or profits interest of the borrower). In addition, the portfolio interest exemption does not apply to certain contingent interest, such as interest determined by reference to any receipts, sales, cash flow, income or profits of, or the fluctuation in value of property owned by, or dividends, distributions or similar payments by, the borrower or a related person.

The beneficial owner of interest must generally submit a properly completed IRS Form W-8BEN-E (or, if an individual, IRS Form W-8BEN) to claim an exemption or reduction available under an applicable income tax treaty or the portfolio interest exemption.

If interest paid to a non-US lender is effectively connected with such lender's trade or business in the United States, such interest will not be subject to US federal withholding as long as such lender submits a properly completed IRS Form W-8ECI, but will generally be subject to net income tax in the United States and, for foreign corporations, branch profits taxes.

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

Foreign Account Tax Compliance Act (FATCA)

Under provisions commonly referred to as FATCA, a 30 per cent withholding tax may be imposed on interest on, and gross proceeds from the sale, redemption, retirement or other disposition of, a debt obligation of a United States person (and certain non-US persons engaged in a trade or business in the US) paid to a foreign financial institution or to a non-financial foreign entity, unless the foreign financial institution enters into an agreement with the IRS and undertakes certain investigation, reporting and other required obligations; the non-financial foreign entity either certifies it does not have any substantial United States owners or furnishes identifying information regarding each substantial United States owner; or the foreign financial institution or non-financial foreign entity otherwise qualifies for an exemption from these rules. Foreign financial institutions located in jurisdictions that have an intergovernmental agreement with the United States governing these rules may be subject to different rules. FATCA withholding tax generally applies to payments of US-source interest made on or after 1 July 2014, and to payments of gross proceeds from a sale or other disposition of debt obligations producing US-source interest on or after 1 January 2019.

Deductions

Interest or original issue discount accruing on an obligation properly treated as debt for US federal income tax purposes will be deductible as such interest or original issue discount accrues, subject to applicable limitations. All US corporations in the same affiliated group within the US are generally able to consolidated returns for US federal income tax purposes.

Under the earning stripping rules, if a foreign affiliate guarantees the debt obligation (or if interest is paid to a foreign affiliate) and the debt-to-equity ratio of the borrower exceeds 1.5:1, deduction of interest may be limited to 50 per cent of the adjusted taxable income of the borrower, and any disallowed interest may be carried over to successive years.

Additionally, if a debt obligation is issued with a 'significant original issue discount' for US federal income tax purposes, matures more than five years after the issue date and its yield exceeds certain thresholds, the debt would be treated as an 'applicable high-yield debt obligation,' in which case original issue discount may not be deducted until paid and the deduction of a portion of original issue discount on the debt may be permanently disallowed. Such limitations can be avoided if the debt obligation provides for adequate partial prepayments after the fifth year ('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

Generally, non-US affiliates that are treated as controlled foreign corporations for US federal income tax purposes will not guarantee the debt obligations of a US borrower, because such a guarantee would result in a deemed dividend to its direct or indirect US shareholders. In addition, to avoid such deemed dividend, no assets of a controlled foreign corporation may be pledged to support the debt obligations of a US borrower, and only up to two-thirds of the voting stock of a first-tier controlled foreign corporation may be pledged in support of a debt obligation of a US borrower. A controlled foreign corporation generally means a foreign corporation that is directly or indirectly or by attribution owned, in the aggregate, by more than 50 per cent (based on vote or value) by United States shareholders. A United States shareholder in this context means a shareholder that is a United States person and owns at least 10 per cent of the foreign corporation. US borrowers should ensure limitations on guarantees and stock pledges to eliminate the potential deemed dividend issues.

III SECURITY AND GUARANTEES

i Guarantees

Guarantees of obligations are typically provided by all material domestic subsidiaries and the direct parent (if any) of the borrower. While there are corporate limitations on the value of guarantees by subsidiaries of the obligations of their parent entities, such limitations do not typically affect the taking of such guarantees, only potentially the value thereof in an enforcement or bankruptcy proceeding. Nevertheless, particularly in the case of non-wholly owned subsidiaries, the organisational documents of guarantors should be reviewed to ensure that any guarantees are within the capacity of the guarantor. In the case of a guarantee that is required by the principal obligations and is being issued contemporaneously with the principal obligation, separate consideration to the guarantor is not required under New York law nor the law of many other states, although laws may vary among the states. Where the guarantee is not contemporaneous with the principal obligation, New York law provides that such guarantee is enforceable as long as any consideration is recited in the guarantee and proven to have been given, and would be valid consideration except for at the time that it was given.[2] The Restatement (Third) of Suretyship & Guaranty takes a similar position, but not all states follow this approach and in some states separate consideration may be required for a guarantee executed after the primary obligation. For example, Section 2792 of the California Civil Code provides that:

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

> *Where a suretyship obligation is entered into at the same time with the original obligation, or with the acceptance of the latter by the creditor, and forms with that obligation a part of the consideration to him, no other consideration need exist. In all other cases there must be a consideration distinct from that of the original obligation.*

In addition, as noted above, except in limited circumstances, because of the adverse tax consequences arising under the US Tax Code, subsidiaries organised outside of the US do not provide guarantees of obligations of a US borrower.

Whether the guarantee is immediately enforceable would depend on the terms of the guarantee. A guarantee of collection would generally require the holder of the guaranteed obligation to first exhaust its remedies against the principal obligor prior to seeking payment from the guarantor (unless the principal obligor is insolvent or the subject of an insolvency proceeding). In contrast, guarantees of payment, which are much more typical, do not require the holder of the guaranteed obligation to pursue its remedies against the principal obligor prior to seeking to enforce the guarantee.

ii Security

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

iii Perfection and creation

To create a valid security interest in those categories of collateral governed by the UCC, a grantor must execute or authenticate a written or electronic security agreement that provides an adequate description of the collateral, the grantor must have rights in the collateral or the power to transfer such rights, and value must be given. A security interest in most types of collateral governed by the UCC may generally perfected by the filing of a notice filing under the UCC, referred to as a UCC financing statement.

iv Receivables

In addition to the general rules set forth above, if the receivable is evidenced by an instrument or chattel paper (a receivable secured by a specific good, such as a loan secured by a particular automobile, or a lease of specific goods, such as a lease of an automobile), perfection by possession or control of the instrument or chattel paper is preferable to perfection by a UCC financing statement as possession or control may entitle the secured party to higher priority and protect the secured party from third parties acquiring better rights in the collateral. Possession means physical possession of the original instrument or tangible written chattel paper by the secured party or an agent of the secured party (the grantor cannot be the agent of the secured party for purposes of perfection by possession). In the case of a chattel paper that exists solely in electronic form, an electronic equivalent of possession known as 'control' is legally possible; however, the rules are complex, and counsel should be consulted if this method of perfection is desired. As noted earlier, if the underlying obligor is a federal, state or local governmental entity, compliance with various special laws applicable to such obligors may be necessary or advisable.

v Moveable assets and inventory

Consistent with the general rule, a security interest in inventory and equipment is generally perfected by the filing of a UCC financing statement. For most US corporations, limited liability companies and limited partnerships, the UCC financing statement would be filed in the jurisdiction in which such entity was formed, although there are exceptions for certain entities and certain collateral.

vi Securities and securities accounts

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

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

The final method of holding securities is through a securities account maintained by a financial institution referred to as a securities intermediary. This is the most common method of holding investment securities (whether debt or equity). The interest of the grantor in the securities maintained in a securities account is referred to as a security entitlement. Perfection of a security interest in these security entitlements can be accomplished by either the filing of a UCC financing statement or by the secured party obtaining control thereof. Control can be accomplished by the secured party entering into an agreement, commonly referred to as a securities account control agreement, with the securities intermediary whereby the securities intermediary agrees that it will comply with the instructions originated by the secured party directing the transfer or redemption of the underlying security without further consent by the grantor. Control can also be achieved by the secured party becoming the owner of the security entitlement on the books and records of the securities intermediary. As with the other methods of holding securities described above, perfection by control is preferable to perfection by a UCC financing statement as control entitles the secured party to higher priority and may protect the secured party from third parties acquiring better rights in the collateral. The United States is a party to the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary (the Hague Convention). The Hague Convention contains choice of law rules applicable to the law governing, among other things, perfection of a security interest in securities held in a securities account, and contains limitations on the parties ability to select the law governing such security interest. If the relevant securities intermediary does not maintain a qualifying office in the United States, the choice of US law or the law of a US state will not be respected.

It is worth noting that many US companies are not organised as corporations but rather as limited liability companies or limited partnerships. Interests in most limited liability companies and limited partnerships would not be classified as securities under the UCC unless the issuer thereof makes a voluntary election to so treat the membership interests or partnership interests or such interests are publicly traded. If the interests are not securities and are not credited to a securities account they will be 'general intangibles', which can only be perfected by the filing of an appropriate UCC financing statement.

vii Cash deposits

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

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

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

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

viii Enforcement

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

ix Bankruptcy and preference concerns

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

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

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

IV PRIORITY OF CLAIMS

i Priority generally

Assuming that the security interest is properly perfected and is not avoided, then the secured party will be entitled to receive the value of its interest in the collateral up to the amount of its secured obligations, ahead of any other claims against the borrower. The value of a secured party's interest in its collateral is generally the value of the collateral less the amount of any obligations secured by a security interest or lien that is senior in priority under applicable state law. All properly perfected secured claims would be paid (up to the value of the collateral securing such claims) prior to the payment of any unsecured claims or claims secured by a security interest that is junior in priority either under applicable law or by contract. In addition, various administrative and other claims given priority by law would be satisfied prior to the payment of any unsecured claims. No parties (including governmental agencies and employees) are given any automatic statutory priority over secured creditors as a result of the US Bankruptcy Code. The status and priority of secured creditors are determined almost exclusively by reference to applicable non-insolvency law, and the Bankruptcy Code generally does not affect such status and priority. Under the Bankruptcy Code, the bankruptcy court may grant a security interest with priority over all other security interests to a lender providing new financing to the borrower; however, such security interests may only be granted if either the lenders being primed by the new security interest consent, or if the bankruptcy court decides that the terms of the transaction provide the lenders being primed with adequate protection – a judicial determination that the recovery of the lenders being primed on the secured claims should not be negatively affected by the new financing and security interest.

Under non-bankruptcy law, a properly perfected security interest generally will have priority over a later-filed tax lien in favour of the United States for federal income taxes if the collateral is in existence on the date of the issuance of the federal tax lien or, subject to certain conditions, arises within 45 days of the filing of the tax lien. The United States will generally have priority over collateral (e.g., inventory and receivables) arising more than 45 days after the filing of the tax lien, and the United States would also have priority in all collateral if the tax lien predated the security interest. The rules applicable to various other federal and state governmental liens vary, and an examination of the particular lien law would be required.

ii Equitable subordination

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

iii Treatment of intercreditor or subordination agreements

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

V JURISDICTION

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

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

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

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

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

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

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

VI ACQUISITIONS OF PUBLIC COMPANIES

i Methods of acquisition

Acquisitions of public companies are generally accomplished through one of two methods. The first is a consensual process by which the board of the target and the acquirer approve the acquisition and then solicit approval of the transaction by a majority vote of shareholders. The second is to consummate the acquisition through a direct tender offer for the shares followed by a squeeze-out merger of any remaining minority holdings. A tender offer will not require the approval of the target board to be commenced and may be adversarial. While there are considerable federal regulatory requirements relating to public company takeovers as well as significant state laws that will affect the structuring of the acquisition, other than the margin regulations mentioned earlier, such rules are not directed at the financing. The limited conditionality of such financing that is typically found is driven by both the competitive dynamics among potential bidders and the fiduciary duties of the board to approve the 'most certain' transaction.

ii Disclosure of financing terms

As part of the public disclosure required for the solicitation of votes on a merger agreement or the solicitation of shares pursuant to the tender offer, a generic sources and uses, which would include fees, must be provided. Market flex terms generally do not need to be disclosed.

iii Confidentiality prior to consummation of acquisition

Prior to consummation of the acquisition, securities rules that apply to material non-public information (MNPI) would limit any potential lender from trading in the debt or equity securities of the target if in possession of MNPI. Syndication processes are generally structured to allow lenders who do not wish to receive such MNPI to have access only to materials that do not contain MNPI.

iv Margin regulations

Financing of acquisitions of public companies, including take-private transactions, can often raise issues under the US margin regulations discussed above. Even in the absence of a pledge of publicly traded securities, certain transaction structures can create a presumption of indirect security over such securities. The existence of such indirect security can trigger the margin regulation restrictions on the amount of credit that can be extended, either as loans or debt securities.

VII OUTLOOK

The market continues to be robust. Term loan investors continue to support covenant-lite transactions and, in many cases, the credit agreement package of negative covenants will substantially mirror a high-yield bond indenture. The Leveraged Lending Guidance provided by certain banking regulators on 21 May 2013 has had a significant impact on reduced leverage overall and the careful scrutiny of some terms. The regulators, the office of the Comptroller of the Currency, the Federal Reserve and the Federal Deposit Insurance Corporation have jurisdiction over many, but not all, of the market participants that arrange and syndicate the loans typically used in the leveraged acquisition market. The Leveraged Lending Guidance has put pressure on the regulated institutions to ensure that the deals brought to market have certain metrics, including repayment through cash flow and leverage limitations consistent with industry profiles.