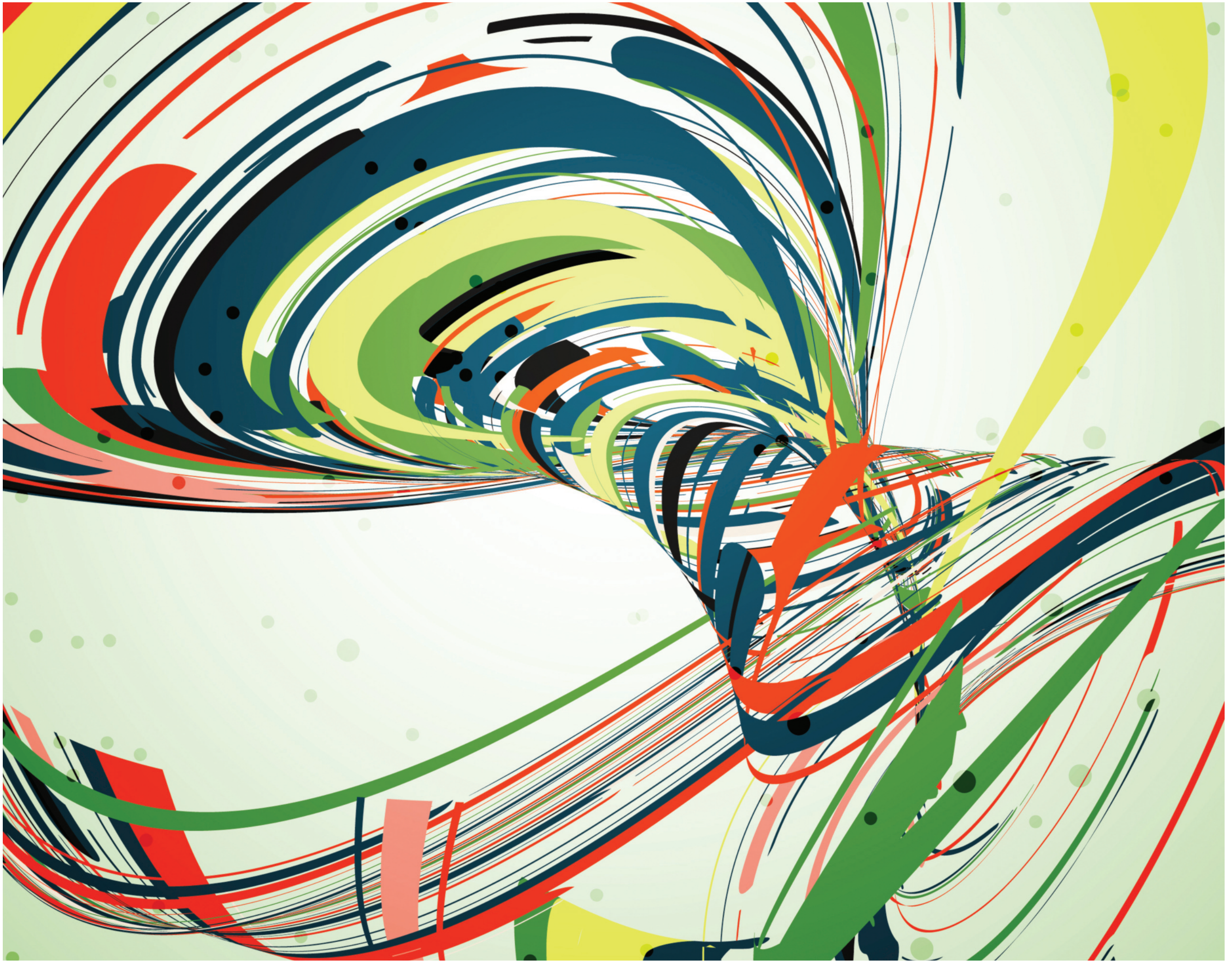

Cross-border Financing Report

US

Scott Forchheimer and Jennifer Kent, Latham & Watkins

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SECTION 1: MARKET OVERVIEW

1.1 Please provide an overview of the market and environment for cross-border financing in your jurisdiction.

Despite gradual increases in short-term interest rates over the past couple of years, interest rates in the US remain relatively low. That, combined with the flexibility found in covenant-lite loans, makes the US loan market appealing to borrowers. The low risk of borrower default and deep supply of loans makes the market appealing to lenders.

Financings can take many forms: the size can range from large-cap to middle-market to small-cap; the lenders can be traditional banks, funds, or other alternative lenders; the loans can be widely syndicated or closely held. We continue to see a variety of financing structures, including bank/bond, first lien/second lien, stretch first lien, and mezzanine financings, all of which can involve cross-border transactions.

1.2 Have there been interesting changes in the structure of the banking sector in your jurisdiction?

Recent developments include:

Leveraged lending guidance:

In 2013, the Office of the Comptroller of the Currency of the US Department of Treasury (OCC) issued guidance on leveraged lending (the Guidance). The Guidance has been interpreted to limit pro forma leverage for loans to 6.0x, and until recently banks have viewed the Guidance as a hard rule and restricted their lending accordingly.

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In October 2017, the General Accountability Office (GAO) stated that the Guidance was a rule under the Congressional Review Act and thus could be reviewed by Congress, creating the possibility of reversal. In February 2018, the head of the OCC stated: 'I am supportive of banks doing leveraged lending…as long as it does not impair safety and soundness.' These statements have demonstrated to banks that the Guidance may be looser than previously thought, and we are already seeing increased leverage levels (eg 7.0x) becoming more prevalent in large cap financings.

LIBOR Phase-out:

In July 2017, the Financial Services Authority (FSA) of the UK announced concerns about the future of Libor, stating that the 'absence of active underlying markets [for the Libor rate] raises a serious question about the sustainability' and noting the rate's vulnerability to misconduct. For these reasons, the FSA has recommended that an alternative benchmark be implemented within the next several years. Borrowers and lenders have begun to incorporate Libor successor provisions into new loan documentation and amendments to existing loans to more readily allow for incorporation of a successor benchmark once chosen by the market.

FinCen Customer Due Diligence Rule:

The Financial Crimes Enforcement Network (FinCen) issued a new customer due diligence rule that took effect in May 2018. The rule requires financial institutions to collect and verify identification information for beneficial owners of legal entity customers. Beneficial owners include certain individuals who (a) have significant responsibility to control, manage, or direct the entity or (b) directly or indirectly own 25% or more of the equity interests thereof.

Determining who constitutes a legal entity customer is fact-specific and subject to a number of exclusions, but ultimately could include both borrowers and guarantors in any given financing. Practically speaking, this rule will result in increased know-your-customer (KYC) requirements as well as the insertion of additional covenants and representations in the loan documentation related to beneficial ownership.

SECTION 2: FINANCING STRUCTURES

2.1 What have been the key trends or developments in your jurisdiction over the past 12 months in terms of financing structures, deal drivers and the way borrowers and creditors are participating in the market?

The US market continues to produce a large number of covenant-lite, term loan B financings, often coupled with a revolving facility. All of the structures noted in Section 1.1 are commonly utilised. In addition, non-bank lenders and direct lenders continue to be an increasing and reliable source of capital, both in the middle market and on second lien term loans.

The loan market has seen increased volatility in Q3 of 2018. As a result, arrangers have been exercising flex rights more often and more broadly. Nevertheless, private equity sponsors are still generally successful in negotiating for borrower-friendly terms such as increased restricted payment flexibility, exceptions from most favoured nation pricing protection on incremental facilities, and asset sale prepayment exceptions.

2.2 Briefly outline some recent notable transactions involving your jurisdiction, highlighting any interesting aspects in their structures and what they might mean for the market.

The J Crew transaction from late 2016 elicited renewed focus on investment/restricted payment capacity and flexibility with unrestricted subsidiaries. In a controversial set of transactions, J Crew effectively transferred a significant amount of intellectual property to an unrestricted subsidiary, resulting in a release of security in

favour of its secured creditors. While technically compliant with the terms of the loan documentation, this transaction has caused lenders to narrow in on loose investment carve-outs in order to limit unintended impacts on collateral.

SECTION 3: LEGISLATION AND POLICY

3.1 Describe the key legislation and regulatory bodies that govern cross-border financing in your jurisdiction.

Regulatory bodies and laws governing financings in the US include:

- Federal Reserve System: The central bank of the US, responsible for, among other things, regulating certain financial institutions and financial activities.
- Securities and Exchange Commission (SEC): Regulates the securities markets and supervises the participants therein, including investment advisors and broker/dealers.
- OCC: Supervises all national banks and federal savings associations.
- State regulators: Each state has its own regulatory agencies tasked with overseeing financial markets and the participants therein.
- Dodd-Frank Wall Street Reform and Consumer Protection Act: A 2010 federal law regulating banks and the financial industry as a whole.
- Securities Exchange Act: A 1934 law governing securities transactions.
- Uniform Commercial Code: A law adopted by each state (with certain state-specific variations) that governs the creation, perfection and priority of security interests in the US.

In addition, while not a regulatory body, the Loan Syndications and Trading Association (LSTA) is a non-profit organisation that works to develop policies and guidelines, promote equitable market principles, and prepare standard documentation for the US syndicated loan market.

3.2 Have there been any recent changes to legislation or regulations that may impact the cross-border financing market or availability of funding in your jurisdiction?

See Section 1.2.

In addition, the US administers a variety of sanctions programs which are subject to ongoing update. To the extent a US financing involves a company with operations in any country subject to US sanctions programs, borrowers should expect a more stringent KYC process as well as narrowly-tailored covenants and representations and warranties related to use of proceeds and sanctions/anti-corruption.

3.3 Are there any rules, legislation or policy frameworks under discussion that may impact lenders or borrowers involved in cross-border financing in your jurisdiction? How can market participants prepare?

See Section 1.2.

SECTION 4: LOCAL MARKET NORMS

4.1 Are there frequently asked questions from new market entrants or often overlooked areas from parties involved in cross-border financings in your jurisdiction?

In the leveraged buyout context, parties should be cognisant of the nuances of US acquisition agreements and their impact on financing terms and process. Two notable examples are below:

Xerox provisions: These are provisions that are inserted into the remedies, venue, waiver of jury trial, third-party beneficiaries and amendments sections of a purchase agreement, intended to limit the recourse a seller may have against the buyer's financing sources. Xerox provisions are commonplace in the US market and so US lenders will expect these, even in non-US purchase agreements, if there is a US financing.

Certain funds: The certain funds concept, while typical in Europe, is relatively uncommon in the US market. Lenders who primarily participate in the US market may be unfamiliar with the differences in process and documentation required in a certain funds deal. If you plan to have a US financing in connection with a certain funds-style acquisition, you should raise this with your financing sources as early as possible to ensure a smooth process.

4.2 Please describe any common mistakes or misconceptions that exist about the financing market in your jurisdiction.

Many of the relevant laws are state law, not federal law, and thus are not uniform across the US. In addition, lenders often assume that in order to file a UCC-1 financing statement in the US against a non-US loan party, such filing must be made in Washington, DC. In reality, the rule is a bit more nuanced and the correct jurisdiction may be elsewhere. As such, local counsel should be engaged in each individual state where a loan party is located, as well as in the state whose law governs the loan documentation.

Moreover, on cross-border financings, non-US banks may request US legal opinions consistent with what is regularly provided in their non-US jurisdiction, including opinions on choice of law, submission to jurisdiction and stamp duty. These are not common in US opinion practice, and due to the aforementioned nuances in state laws can often necessitate US local counsel in the states of organisation of the relevant US entities.

4.3 Are there any classes of assets over which security cannot be taken or regulations specific to your jurisdiction governing the taking of security over certain classes of assets that lenders should be aware of?

There are a few classes of assets for which there are regulatory, contractual or other legal restrictions on granting security, such as certain equipment leases, margin stock, assets of gaming companies, and governmental licences.

Beyond formal legal restrictions, there are assets with respect to which the creation and/or perfection of a security interest is not

market, usually as a result of burdensome perfection requirements or negative financial consequences. Some examples include motor vehicles, certain intent to use trademarks, and real property located in a flood zone. The most prevalent example is with respect to certain non-US subsidiaries of a US entity, and US subsidiaries that hold no substantial assets other than equity and/or debt of non-US subsidiaries. There can be material tax consequences under Section 956 of the US Internal Revenue Code if these entities provide guarantees or security in support of an obligation of a US entity, or if more than 65% of the equity interests of any such entity are pledged as collateral for the obligations of a US entity.

4.4 What measures should be taken to best prepare for your local market norms?

Security and perfection rules differ widely among states and market standards vary based on the size of the transaction, the industry of the debtor, the structure of the loan and the composition of the lender group. As such, lenders and borrowers alike should consult appropriate US counsel as early as possible in the financing process.

In addition, there is often a distinction in approach to security in bond financings, where a collateral agent/trustee will not exercise discretion in making exceptions to the security package or granting deadline extensions. Therefore, careful consideration should be given when negotiating the terms for security on bond financings, particularly on cross-border transactions that may involve more complex security.

SECTION 5: PRACTICAL LEGAL CONSIDERATIONS

5.1 Briefly explain (i) the typical security package available at closing and (ii) any downstream, upstream and cross-stream guarantees available in your jurisdiction, in each case, with reference to any specific restrictions or limitations.

The typical security package consists of substantially all personal property, subject to certain exceptions (as briefly discussed in Section 4.3 above). Owned real estate and leaseholds over a certain threshold may be included as well.

Security interests in personal property can be granted in one universal security document. However, ancillary filings, notices and other documentation or actions may be required to perfect the security interest in certain assets, such as US federally registered intellectual property, deposit accounts and certificated equity interests. The requirements to grant a security interest in real property vary from state to state, but generally speaking at a minimum a mortgage or deed of trust will be needed.

The US does not have explicit financial assistance or corporate benefit laws. Downstream guarantees are generally unrestricted. Upstream and cross-stream guarantees are extremely common, but you must consider the facts of the transaction to ensure they are permissible under state law. Ultimately, guarantees will be subject to bankruptcy and fraudulent conveyance laws, as well as certain limitations (including with respect to certain swap obligations).

5.2 Are there any specific issues or challenges creditors should be mindful of regarding an insolvency or restructuring situation? Have there been any major judicial changes to the insolvency system (or related judicial decisions) in your jurisdiction recently? How long does an enforcement process typically take?

The federal insolvency regime is the US Bankruptcy Code (the Code). The two types of bankruptcy cases most typically applicable to debtors in the leveraged loan markets are (a) a liquidation under Chapter 7 of the Code and (b) a reorganisation under Chapter 11 of the Code.

Commencement of a bankruptcy case creates an automatic stay against any creditor's enforcement, repossession or collection actions against the debtor or the debtor's property, regardless of whether such creditor is secured or unsecured. The bankruptcy court has broad power, and could set aside transfers that the debtor made when insolvent, or that were made within a certain period prior to the bankruptcy case being commenced. Additionally, security interests that are unperfected at the time the bankruptcy case is commenced could be invalidated.

There is no hard rule for how long a bankruptcy case will last – it depends on a number of factors including whether the case is brought under Chapter 7 or Chapter 11, the size of the debtor, the number of creditors, and the competing interests thereof.

SECTION 6: OUTLOOK

What are your market outlook predictions for the next 12 months in cross-border financing in your jurisdiction?

Barring any market or global disruptions, we expect that we will continue to see active and borrower-friendly debt markets in the US. Interest rates remain relatively low, providing opportunity for refinancings, and private equity sponsors and borrowers continue to push the envelope for favourable terms. We expect continued convergence of terms in bank debt financings and bond issuances, as well as more consistency in provisions in US deals and cross-border matters. Finally, we envision the continued and increased use of alternative lending products, including unitranche and privately placed facilities, in order to offload market and syndication risk.

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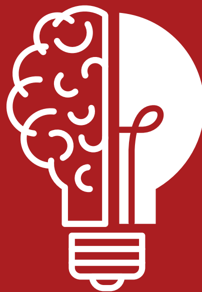

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