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In the early 1980s, leveraged loans and high-yield bonds began to be used to finance leveraged buyouts (LBOs) and other acquisition transactions. Those were simpler times. Back then, leveraged finance was principally a US phenomenon. The annual aggregate amount of leveraged loans and bonds issued in a year was a few tens of billions. Some of today’s top-tier private equity shops were just getting started, and were certainly not household names. The documentation and relevant legal issues, while significant, were a fraction of those that are involved in leveraged finance today.

My, how things have changed. While loans and bonds are still a standard feature of the leveraged finance product menu, they have taken on different shapes and flavours, and additional financing products have been developed and are now widely used. The number of participants in leveraged finance has grown massively, and a large number of the players are now based in Europe and Asia. In addition to banks and institutional investors, direct lenders have now joined the party. Standard documentation for most types of leveraged finance has at least doubled in size. The amount of leveraged loans issued in 2017 for M&A exceeded US$300 billion in the US alone,\(^1\) with the LBO M&A subset posting the second-highest year ever of issuances at US$126 billion (a 44 per cent increase compared to 2016).\(^2\)

While there have been ups and downs, of course, for leveraged finance over the past 40 years (most notably during the financial crisis), leveraged finance used to support acquisitions has become a very big business and is almost certainly here to stay (and probably grow).

This volume is intended to contribute to the knowledge base of lawyers who participate, or aspire to participate, in leveraged finance used for acquisitions. It will hopefully provide an overview and introduction for the novice and be a ready resource for an active practitioner who needs to know about relevant laws and practices in jurisdictions around the world.

Thanks to my partners Casey Fleck and Doug Landy, and my associate Gabi Paolini, for their help in editing the volume and preparing the Introduction that follows.

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I  OVERVIEW

The leveraged acquisition lending market in the United States continues to be robust, with financing available from a multitude of different types of financing sources providing a mix of debt products, including covenant-lite term loan facilities that are broadly syndicated, high-yield bonds, middle market ‘club deal’ term loans and both cash flow and asset-backed revolving facilities for ongoing working capital needs. Acquisitions are financed using these debt products depending on the size of the deal, credit profile and other deal-specific considerations. Financing sources include commercial banks, investment banks and institutional investors including collateralised loan obligations, hedge funds, loan participation funds, pension funds, mutual funds, business development companies and insurance companies. Over US$2.5 trillion of loans were issued to corporate borrowers in the United States in 2017, and a record-setting US$1.4 trillion of those were leveraged loans. This represented a 60 per cent increase in leveraged lending from 2016.2

II  REGULATORY AND TAX MATTERS

i  Regulatory issues

Regulatory issues arise in a number of contexts in connection with leveraged and acquisition financings. Non-US banks or non-bank lenders may, depending on the breadth and geographical location of their activities, be subject to federal or state licensing requirements. Additionally, US financial institutions and non-US financial institutions that maintain a formal US banking presence are subject to anti-money laundering laws and regulations, and all US persons must comply with sanctions regulations issued by the Treasury Department’s Office of Foreign Assets Control. Certain prudential limitations may also apply: lenders that extend credit to a borrower that uses the proceeds to purchase publicly listed equity securities may be subject to US margin regulations, and US financial institutions that engage in leveraged lending are subject to supervisory guidance issued by the federal banking regulators regarding safe and sound lending practices. Other issues may arise where a loan is secured by government receivables, or where a bank attempts to condition the availability of a loan on the customer also obtaining another product or service from the bank or its affiliate.

1 Lauren Hanrahan, Eschi Rahimi-Laridjani and Douglas Landy are partners and Morgan Lingar, James Kong and Archan Hazra are associates at Milbank, Tweed, Hadley & McCloy LLP.
Licensing
The question of whether commercial lending activity triggers any licensing issues is often a fact-specific analysis that may depend on the location of the lender, the location of the borrower and potentially, the location of the collateral. As a general matter, acting as a lender of record under a commercial, syndicated loan would not in itself cause non-US lenders that do not maintain a formal US banking presence to be subject to any specific licensing requirements under federal law. However, if a foreign bank regularly engages in the ‘business of banking’ in the United States, or if it would like to develop and maintain ongoing relationships with US borrowers, the Federal Reserve may require the bank to maintain a formal US presence in the form of a chartered bank or a licensed US branch or agency office. Additionally, a number of states have licensing regimes applicable to non-bank lenders acting in that state, although many of these states exempt non-bank lenders that make large commercial loans from those licensing requirements. Engaging in loan collection activities or enforcing on collateral may also trigger authorisation requirements in a number of states, although in the context of a syndicated loan, these requirements would generally only apply to the extent the lender is acting in the capacity of the administrative or collateral agent.

Anti-money laundering and sanctions
All US persons, including US financial institutions and the US operations of foreign banking organisations, are required to comply with sanctions regulations issued by the Treasury Department’s Office of Foreign Asset Control. These regulations generally require financial institutions to block the accounts and other property of certain ‘targeted’ countries, entities and individuals and to reject any dealings or transactions with these targeted groups or individuals. Additionally, all US financial institutions (including the US banking operations of foreign banking organisations) are subject to US anti-money laundering, know-your-customer, reporting, and other similar requirements.

In May 2018, regulations issued by the Treasury Department’s Financial Crimes Enforcement Network regarding beneficial ownership information came into effect. These regulations require all subject financial institutions to obtain, with certain exceptions, a certification from each legal entity customer that identifies the beneficial ownership information of that customer. A financial institution must obtain this information from the customer each time an ‘account’ is opened with that institution. An ‘account’ is defined broadly as the establishment of any formal banking relationship between the institution and the customer, and includes an extension of credit (or even a renewal of an existing credit).

Margin regulations
The US margin regulations impose restrictions on the amount of credit that may be extended by a US lender to any person for the purpose of buying or carrying ‘margin stock’ (a ‘purpose credit’), if the credit is secured ‘directly or indirectly’ by margin stock. Margin stock generally includes, with certain exceptions, any equity security traded on a national securities exchange. ‘Direct’ security encompasses legally recognised security interests such as liens and pledges, while ‘indirect’ security includes, among other scenarios, arrangements where the borrower’s right or ability to sell, pledge or otherwise dispose of margin stock owned by the borrower is in any way restricted while the credit remains outstanding. Negative pledges or covenants prohibiting the sale or transfer of assets give rise to an indirect security, as does an agreement by the borrower to directly pledge margin stock as collateral at a later date.
The margin regulations are subject to a number of fact-specific exemptions and safe harbours, including exemptions for credit extended ‘outside the United States’. In the absence of an available exemption, the loan amount may not exceed the ‘maximum loan value’ of the collateral securing the credit. The maximum loan value of margin stock is 50 per cent of the market value of the margin stock, while all other collateral has a maximum loan value equal to its ‘good faith loan value’ (not to exceed 100 percent of the current market value of the collateral).

**Leveraged lending guidance**

In March 2013, the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation issued a joint ‘Interagency Guidance on Leveraged Lending’. US banking organisations are subject to the guidance on an enterprise-wide basis, while foreign institutions are subject to the guidance with respect to leveraged loans that are originated and distributed in the United States. The guidance discusses the agencies’ expectations with respect to the leveraged lending process, including with respect to underwriting standards, valuation standards and pipeline management.

In June of 2017, the Treasury Department released a report reviewing the current US financial regulatory landscape and presenting potential changes and recommendations for reform, including with respect to the leveraged lending guidance. The report acknowledged concerns regarding the guidance presented by market participants, and in particular, highlighted the level of ambiguity left in the definition of leveraged lending. In late 2017, the US Government Accountability Office deemed the guidance to be a ‘rule’ that should have been submitted for Congressional review under the Congressional Review Act, and the then-heads of the US bank regulatory agencies responded by submitting letters to Congress indicating that the agencies would consider revising and reproposing the guidance for public comment. As of this writing, however, the guidance has not been reproposed. In September 2018, the three federal bank regulatory agencies and the National Credit Union Administration issued a joint statement clarifying that supervisory guidance does not have the force and effect of law, but rather outlines the agencies’ supervisory expectations and priorities. Nevertheless, non-compliance with the terms of a guidance may lead a regulator to determine that a subject financial institution is engaged in unsafe or unsound practices.

**Federal Claims Act**

Issues under the Federal Assignment of Claims Act may arise where a loan is collateralised by receivables from the US government. As a result, banks should ensure that any assignments of such receivables are compliant with the requirements and procedures specified in the statute. Similar issues may arise in a number of states or municipalities that maintain analogous laws.

**Anti-tying rules**

US bank anti-tying rules generally prohibit any US bank, as well as the US branches and agencies of foreign banking organisations, from conditioning the availability of (or varying the prices of) credit (the ‘tying’ product) on a customer also obtaining an additional product or service from the bank or its affiliate (the ‘tied’ product). For example, a bank may not tell a client that it will not participate in a bridge loan to the client unless such client also engages the bank as underwriter for a related bond offering. Certain fact-specific exceptions and safe
harbours to the general prohibitions are available, including those available where the tied product is a ‘traditional bank product’ (such as another loan), or where the borrower is a foreign entity organised and having its principal place of business outside the United States.

ii Tax issues

Withholding taxes

The United States generally imposes a 30 per cent federal withholding tax on US-source interest paid to a non-US lender. For these purposes interest is generally US-source if it is paid on a debt obligation of a US person (such as a US corporation) or of certain non-US persons engaged in a US trade or business. A 30 per cent federal withholding tax may also be imposed on other payments made under loan agreements, such as letter of credit and other fees.

Interest is exempt from this withholding tax if a non-US lender qualifies for the ‘portfolio interest exemption’. In order to qualify, a non-US lender must not (1) be a bank receiving interest on an extension of credit entered into in the ordinary course of its trade or business, (2) be a controlled foreign corporation (as defined for US federal income tax purposes) related to the borrower or (3) own 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 the capital or profits interests in the borrower). The non-US lender must also submit a properly completed IRS Form W-8BEN-E or W-8BEN (if it is an individual). Moreover, the debt obligation itself must be in ‘registered form’ for US federal income tax purposes and interest on the debt obligation cannot be determined by reference to receipts, sales, cash flow, income or profits of, the change in value of property owned by, or dividends, partnership distributions or similar payments by, the borrower or a related person (i.e., ‘contingent interest’).

The US federal withholding tax on interest can also be eliminated or reduced under an income tax treaty between the United States and the non-US lender’s home jurisdiction, provided the non-US lender is eligible for the benefits of the treaty. Treaties may also exempt fee income from US federal withholding tax. In order to claim treaty benefits, a non-US lender generally must submit a properly completed IRS Form W-8BEN-E or W-8BEN.

If a non-US lender is engaged in a US trade or business (such as the US branch of a non-US bank), US-source interest and fees that are effectively connected with that trade or business are not subject to US federal withholding tax. Instead, such amounts are subject to US federal net income tax and, for foreign corporations, the branch profits tax. To avoid gross basis withholding such a non-US lender is required to provide IRS Form W-8ECI to the borrower.

FATCA

Under the provisions commonly referred to as ‘Foreign Account Tax Compliance Act’ or FATCA, a 30 per cent withholding tax may be imposed on payments of US-source interest on and fees with respect to, on or after 1 January 2019, gross proceeds from the sale, redemption, retirement or other disposition (which would include the repayment of principal) of, a debt obligation that produces US-source interest. The withholding tax applies to payments to ‘foreign financial institutions’ that do not (1) enter into an agreement with the US Internal Revenue Service under which they undertake certain due diligence, reporting and other obligations or (2) comply with legislation in their home jurisdictions implementing the intergovernmental agreement between the United States and their home
jurisdiction relating to FATCA pursuant to which they need to undertake similar obligations. FATCA withholding also applies to payments to certain non-financial foreign entities unless such an entity either certifies that it has no ‘substantial United States owners’ or provides certain identifying information about each owner. Debt obligations issued before (and not significantly modified on or after) 1 July 2014 are exempt from FATCA withholding under a grandfathering rule.

**Deductions**

Interest and original issue discount on an instrument treated as debt for US federal income tax purposes is generally deductible as it accrues, subject to various limitations. Affiliated corporations filing a consolidated US federal income tax return generally are permitted to deduct interest against the group’s income.

Legislation passed at the end of 2017 limits net business interest expense deductions for most businesses, regardless of form, to 30 per cent of their ‘adjusted taxable income’. Net business interest expense is the excess of ‘business interest expense’ over ‘business interest income’. The disallowance does not apply to ‘investment interest,’ but the US Internal Revenue Service has provided guidance that a C corporation will not be treated as having ‘investment interest’ for this purpose. Thus, all interest income and interest expense of a C corporation will generally be accounted for in computing the limitation. For tax years beginning 2018 to 2021, adjusted taxable income should approximate a business’ EBITDA. For tax years beginning after 2021, it should approximate EBIT.

Original issue discount on ‘applicable high yield debt obligations’ or ‘AHYDOs’ may not be deducted until paid and, depending upon the yield of the instrument, a portion of the deduction may be permanently disallowed. A debt obligation is an AHYDO if, for US federal income tax purposes, it is issued with ‘significant original issue discount’, has a maturity in excess of five years and has a yield in excess of certain statutory thresholds. In practice, the limitation on deductions can be avoided if the debt instrument provides for adequate prepayments, known as ‘AHYDO catch up payments’.

Deductions for interest and original issue discount are also limited or deferred if a non-US lender is related to the borrower or if the debt is required to be paid in (or principal or interest is required to be converted to or determined by reference to the value of) equity of the borrower or a related party.

**Credit support**

If a controlled foreign corporation guarantees, or directly or indirectly pledges its assets in support of, the obligations of a related US borrower, this credit support could result in a deemed dividend to its direct or indirect ‘United States shareholders’. As a result, a controlled foreign corporation generally is not required to guarantee the debt obligations of an affiliated US borrower, and no assets of a controlled foreign corporation may be pledged to support the debt of an affiliated US borrower. In addition, no more than two-thirds of the voting equity of a first tier controlled foreign corporation may be pledged in support of such debt.

A controlled foreign corporation is a non-US corporation more than 50 per cent of the vote or value of which is owned, directly, indirectly or by attribution, by United States shareholders. A United States shareholder is a United States person that owns 10 per cent or more of the vote or value of a non-US corporation. Legislation enacted at the end of 2017 broadens the application of the constructive ownership and attribution rules, resulting in more foreign corporations being treated as controlled foreign corporations. Under current
rules, foreign subsidiaries of a foreign parent company may be controlled foreign corporations if the foreign parent also owns a US subsidiary. While non-US subsidiaries of non-US parent companies may now be controlled foreign corporations, deemed dividends only result in adverse US tax consequences if equity in such a controlled foreign corporation is owned directly, or indirectly through other non-US entities, by a United States shareholder.

Moreover, deemed dividends only arise if a controlled foreign corporation has earnings that have not been previously taxed in the United States. Owing to the deemed repatriation of offshore earnings pursuant to tax legislation enacted at the end of 2017, the amounts of such untaxed earnings have been greatly reduced. However, many controlled foreign corporations will continue to have earnings that would be taxed less favourably if included as a deemed dividend by a United States shareholder. As a result, loan documents continue to limit, or exclude, guarantees and pledges by or with respect to controlled foreign corporations. However, it should be possible to limit the scope of controlled foreign corporations subject to these limitations to those with direct or indirect United States shareholders.

III SECURITY AND GUARANTEES

i Guarantees

In acquisition financings involving a US borrower, all of the borrower’s material US subsidiaries (subject to customary exclusions) usually provide a guarantee of the borrower’s obligations (an upstream guarantee) for the benefit of the lenders and other secured parties. In addition, a downstream guarantee of the borrower’s obligations is provided by the parent holding company.

ii Security interest

In acquisition financings involving a US borrower, all or substantially of the borrower’s and guarantors’ assets are pledged for the benefit of the lenders and other secured parties (subject to customary exclusions). Other than interests in real property, most security interests are governed by a single security agreement. Some of the assets commonly included in a security agreement are goods, equipment, investment property, securities, securities accounts, deposit accounts and letter of credit rights. The security interest in such collateral typically extends to proceeds and after-acquired assets.

iii Creation and perfection

The Uniform Commercial Code (UCC), which varies slightly by state, governs security interests. A security interest is only good as long as it is attached and perfected. Attachment of the security interest gives the lenders legal rights against the borrower’s assets in the event of default. Attachment requires that value is given to the borrower, the borrower has rights in the collateral and there is a security agreement describing the collateral and executed by the borrower. Meanwhile, perfection gives the lenders’ security interest in the assets priority over the interests of other secured parties in a potential bankruptcy process. Depending on the type of asset, perfection under the UCC can be achieved by filing a financing statement, by possessing the collateral, by controlling the collateral or automatically upon attachment. The perfection of security interests in most types of assets is generally accomplished by the filing of a UCC financing statement in the applicable filing office, which for borrowers that are US corporations, limited liability companies or registered partnerships is the state of organisation.
of the borrower. Certain other asset classes of UCC collateral (described below) are subject to different rules. Real property is subject to mortgages governed by and filed in the law of the state in which the real property is located.

iv Deposit accounts
A lender can only perfect its security interest in a deposit account through control. The lender and the depository bank will typically enter into a control agreement, under which (often upon receipt of notice) the depository bank will manage the funds in the deposit account according to instructions from the lender, without any further consent from the borrower. Deposit accounts can also be automatically perfected if the depository bank and the lender are the same entity.

v Investment property, securities accounts
The most common types of investment property are certificated or uncertificated securities and security accounts. A security account is maintained by a securities intermediary, which can be a clearing corporation or a financial institution. Perfection by control is preferred and can be achieved by the lender and the securities intermediary executing a control agreement. Alternatively, the lender can file a UCC financing statement to perfect its security interest. In the case of certificated securities, perfection by possession is preferred to filing a financing statement, in which case the lender (or its agent) will physically obtain the share certificates. Uncertificated securities may be perfected by control by entering into an agreement between the lender and the issuer of the security or by the filing a UCC financing statement.

vi Intellectual property
The security interests in intellectual property are subject to both the UCC and federal regulations. Filing of a UCC financing statement is generally sufficient to perfect security interests in patents, trademarks, and unregistered copyrights. The Copyright Act, on the other hand, expressly requires recordation with the United States Copyright Office to perfect a security interest in copyright registration or application. US federal courts split on the issue of whether an unregistered copyright can be perfected under the UCC. Consequently, in practice, filings are often made with the United States Patent and Trademark Office (USPTO) or the United States Copyright Office and by UCC financing statement.

IV PRIORITY OF CLAIMS
When the debtor files for bankruptcy under Chapter 7 or Chapter 11, assuming that its security interests are properly perfected and not avoided, the secured lenders will get paid the value of their collateral (up to the amount of their secured obligations) prior to the payment of unsecured claims. If the security interest is not properly perfected or is avoided, it can be effectively subordinated to other claims against the obligors. Moreover, a claim can be subordinated or invalidated in various ways such as through an intercreditor agreement, equitable subordination (described below), fraudulent conveyance (described below), or preference, although notably there are no financial assistance rules in the US.

In the US, intercreditor agreements are generally respected in bankruptcy. US intercreditor agreements generally rely on waivers by junior secured lenders of various secured
creditor rights under the Bankruptcy Code, which are generally respected by the bankruptcy courts, instead of the payment subordination and enforcement standstill provisions that are often seen in intercreditors of some other jurisdictions.

The Bankruptcy Code grants courts discretion to order a claim of a lender with equity or another preferable position to be subordinated if that lender engaged in severe inequitable conduct to the detriment of other lenders.

Furthermore, the Bankruptcy Code (and similar state laws) allows the creditor to claw-back certain transfers made within certain time periods before the debtor files for bankruptcy, where a ‘transfer’ is defined broadly to include non-monetary acts such as the perfection of a security interest. In the case of either actual or constructive fraudulent transfers, a security interest can be invalidated and thus subordinated to other unsecured claims. In the context of acquisition financing, courts look at two factors to determine constructive fraudulent transfers. First, they determine whether there was less than reasonably equivalent consideration, and second, they look to whether the target transferor was insolvent or had inadequate capital at the time of transfer. While upstream and cross-stream guarantees are commonly used and generally permissible, they may be subject to claims of fraudulent transfer.

V JURISDICTION

In credit agreements and debt commitment letters, borrowers and lenders must choose a specific US state to be the governing law. A choice of law provision and a submission to jurisdiction clause determine the substantive law that governs the agreement and the jurisdiction in which to litigate disputes, respectively. Most often, lenders prefer New York governing law and submission to the state and federal courts sitting in New York City, New York. In addition, foreign judgments and awards will generally be respected.

VI ACQUISITIONS OF PUBLIC COMPANIES

i Certain funds

There are no statutorily required conditions precedent to funding a US acquisition financing. The US market has for some time incorporated the ‘Sungard’ approach, which provides comfort to the purchaser and seller under an acquisition agreement that any ‘daylight’ between the conditions to the acquisition and the conditions to the acquisition financing have been mitigated. However, depending on deal dynamics (such as the seller’s expectations and the jurisdiction of the target) financing sources may accept ‘certain funds’ conditionality similar to the construct that is required (in some cases) and customary in the UK M&A market.

ii Margin regulations

Issues under the US margin regulations may arise where a borrower uses the proceeds of a financing for the purpose of acquiring a US public company. Shares of these companies are considered ‘margin stock’ and to the extent such a financing is secured directly or indirectly by margin stock (as discussed above), the loan would be subject to the margin regulations’ limitations regarding the maximum amount of credit that may be extended.
iii Confidentiality

In connection with the shareholder vote to approve the acquisition of a public company, public shareholders of the target will need to be provided with public disclosure that will include a generic sources and uses (but not a description of the flex terms in any debt commitment letters). There are no statutorily required confidentiality requirements or other restrictions on debt issuance or syndication while a public company is pending completion of an acquisition (although the usual concerns about material non-public information will be present).

VII THE YEAR IN REVIEW

The past year has continued to see favourable conditions, increasing interest rates and an increasingly favourable regulatory environment (as discussed above), which has given borrowers significant negotiating power in recent transactions. Recent large acquisition financings, such as Refinitiv, the speciality chemicals business of AkzoNobel and Envision Healthcare, illustrated the strength of the bank and bond markets to complete large acquisition financings. The overall leveraged lending default rate has been inside the historical average of 3.1 per cent and this is unlikely to change materially through the end of 2018. In addition, the finance community over the last year has been interested in the need to find a replacement for LIBOR-based interest rates and determining which construct will be the most likely replacement.

VIII OUTLOOK

The leveraged acquisition lending market looks like it will continue to be strong in the coming months. Rising interest rates have intensified investor appetite for floating rate loans, in particular. The economic outlook for the United States remains generally encouraging. Although always difficult to predict, no new legislative initiatives that would impact the finance markets are expected. Consequently, the fundamentals for leveraged finance remain positive and liquidity remains strong.
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