
ONE FIRM
WORLDWIDE SM
JONES DAY®

CHANGES TO 956: WHAT DOES IT MEAN IN REALITY

Georgia Secured Lending Seminar: March 21, 2019

Angie Batterson
Gayle Berne

A. THE BASICS

- Under the old 956 tax rule, adverse tax consequences could arise if a foreign subsidiary provided credit support for a US Borrower's loan obligations due to the "956 Deemed Dividends Rule" ("956").
- 956 was enacted as an anti-avoidance measure to ensure that earnings and profits of controlled foreign corporations ("CFCs") would be subject to U.S. tax when repatriated via (1) a dividend, (2) a direct loan to a U.S. parent company, or (3) credit support in the form of pledges and guarantees. To comply with 956, credit agreements of U.S. companies with international subsidiaries restrict CFCs from becoming guarantors or granting liens over their assets, and limit any stock pledges to less than 66 2/3% of the voting stock of such CFCs to secure the loan, since the 956 Deemed Dividends Rule could otherwise be triggered and give rise to U.S. tax liability.

B. NEW TAX RULES

- New proposed regulations (the "Proposed Regulations") issued on October 31, 2018 by the Internal Revenue Service (the "IRS") and the Treasury Department will, if finalized, and subject to certain exceptions, eliminate the adverse tax consequences of the "956 Deemed Dividends Rule.
- As a result, Lenders may have the opportunity to expand their collateral packages by obtaining:
  - 100% stock pledges of foreign subs
  - Guaranties of foreign subs
  - Foreign collateral

C. WHAT NOW?

- Slow your roll, it is not that simple!

- Certain local foreign law requirements may impose time consuming and costly regulatory hurdles, such as licensing approvals, legal formalities, filing and perfection requirements, as well as possible withholding tax implications and enforcement risks.

D. LICENSING REQUIREMENTS

- Does your lender need a banking license in the foreign jurisdiction before making loans or obtaining foreign credit support?
  - In certain E.U. countries, such as France and Italy, foreign banks must obtain licenses to carry out lending operations.

1. In France there are different rules for banks and non-banks and the lender must be either (i) licensed as a credit institution (*établissement de crédit*) or financial institution (*société de financement*) in France or (ii) authorized as a credit institution through an E.U. passport (i.e. licensed in another E.U. country and passported in France).

D. LICENSING REQUIREMENTS (CONT'D)

- In Germany, the position is more nuanced. If a U.S. lender specifically targets the German market, a license is required; however, not so, if loans are granted at the borrower client's own initiative. A banking license is generally not required for a U.S. lender if it provides loans only to U.S. borrowers and such loans are supported by guaranties and/or security interests in a German subsidiary's assets.
- Many non-E.U. countries have even more disparate treatment beyond typical lending license requirements:
  - In Taiwan, in addition to obtaining the relevant regulatory authorizations, foreign lenders may also be required to establish a local branch in order to pursue lending operations on a repeat basis.

D. LICENSING REQUIREMENTS (CON'T)

- In China, a local borrower's ability to access foreign loans may be subject to an approved foreign-debt quota, calculated under the supervision of the State Administration of Foreign Exchange.
- In the UAE, U.S. lenders need to comply with other requirements such as hiring local employees.
- Certain categories of lenders may also be exempt from local licensing requirements, such as lending institutions lending money to Singapore corporations or LLPs.
- Given the nuanced licensing requirements for foreign jurisdictions, lenders should consult regulatory counsel in the relevant jurisdiction.

E. ABILITY OF A U.S. LENDER TO TAKE A SECURITY INTEREST IN FOREIGN ASSETS

- Unlike the U.S., many jurisdictions have limitations on obtaining blanket liens and most do not have an underlying commercial law akin to the Uniform Commercial Code ("UCC").
- In some countries, a lender's security interest is restricted to specific assets or classes of charged assets, and a lender's ability to take security over future assets may be subject to certain conditions or notification requirements.
- In many jurisdictions, perfection and priority are governed by numerous statutes and common law rules, with some security agreements requiring notarization in order to be effective.

E. ABILITY OF A U.S. LENDER TO TAKE A SECURITY INTEREST IN FOREIGN ASSETS (CON'T)

- In France, other than the pledge over business undertakings (*nantissement de fonds de commerce*), each security interest only covers one type of asset and no blanket security and/or debenture over all assets is available. Specific formalities apply to each category of pledged assets. However, it is possible to have a master agreement which allows a grant of multiple security over multiple assets under common terms and conditions agreed in such master agreement. Supplemental agreements may be required to be signed for certain assets to ensure validity or enforceability. Restatement of all or part of such terms and conditions through a supplemental agreement may be required under certain circumstances (especially with respect to security over real estate assets where the French notaries may require such an additional agreement).

E. ABILITY OF A U.S. LENDER TO TAKE A SECURITY INTEREST IN FOREIGN ASSETS (CON'T)

- Under German law, it is not possible to grant a security interest over any and all assets of a company, such as a floating change, by a single instrument. A similar effect can, however, be achieved if security is being taken over (substantially) all assets by individual security agreements. Security over different kinds of assets could be created in the same agreement.
  - Security over inventory, fixtures and equipment is usually created by way of a security transfer agreement (does not require notarization).
  - Security over a bank account and cash deposited therein as well as securities accounts is typically created by way of an account pledge (does not require notarization). The account holding bank needs to be notified of the pledge in order for it to be valid.

E. ABILITY OF A U.S. LENDER TO TAKE A SECURITY INTEREST IN FOREIGN ASSETS (CON'T)

- In Italy, it is complicated.
  - Security over accounts is limited to a date certain and notice of the assignment/pledge must be given to (or acceptance given by) underlying account debtor with a mean bearing a date certain at law (*data certa*) (such as notarization made by a court bailiff or by certified e-mail (PEC), or acceptance certified by a notary public
  - Because the agreement is limited to a certain date, it must be refreshed from time to time to cover after acquired property.

E. ABILITY OF A U.S. LENDER TO TAKE A SECURITY INTEREST IN FOREIGN ASSETS (CON'T)

- In Mexico, it is possible to take a blanket security over all assets (certain statutory limitations may apply over assets such as government permits, licenses and certain concession rights). This can be done by a general mortgage (*hipoteca industrial*) or by means of affecting all the obligor's assets into a trust. Such blanket security may include current and after acquired assets.
- In order to be perfected, and thus be effective against third parties (i.e. another lender claiming a priority lien), the general mortgage or trust must be recorded as follows:
  - Trusts must be recorded in the Movable Assets Guaranty Registry ("RUG") (Mexican equivalent of UCC registry), and any transfer of real estate rights must also be recorded in the Public Property Registry.

E. ABILITY OF A U.S. LENDER TO TAKE A SECURITY INTEREST IN FOREIGN ASSETS (CON'T)

- Non-possessory pledge agreements, must be recorded in the RUG.
- Pledge Agreements over shares must be recorded in the corporate record and Ministry of Economy electronic registry and the share certificates must be endorsed and delivered to the lender.

- Any form of security granted in Mexico is subject to court challenges. A lender may not repossess the collateral in any case without guarantor's consent or court order. Any judicial procedure necessary to foreclose may take many months and may be subject to appeal and *amparo* proceedings (constitutional review). Furthermore, any Mexican borrower or guarantor may discharge its obligations by paying sums due in Mexican currency at the rate of exchange published by Banco de México in Mexico as in effect on the date such payment is made.

E. ABILITY OF A U.S. LENDER TO TAKE A SECURITY INTEREST IN FOREIGN ASSETS (CON'T)

- In the U.K. the principal types of security which may be taken under English law are (1) fixed charges, (2) floating charges, (3) mortgages (legal or equitable), and (4) assignments by way of security.
- English law permits lenders to take "all assets" security, whereby a lender takes a combination of fixed and floating charges over substantially all of a borrower's assets. The legal document which effects this is known as a "debenture".
- In terms of priority, lenders holding fixed charges will rank first on insolvency, although only in respect of the funds realized by the assets over which they have a fixed charge. If a fixed charge lender is still owed money following the realization of the fixed charge asset, it will either have to rely on its floating security (if any) or become an unsecured creditor in respect of his remaining debt.

E. ABILITY OF A U.S. LENDER TO TAKE A SECURITY INTEREST IN FOREIGN ASSETS (CON'T)

- Floating charges on the U.K. rank behind fixed charges, the liquidator and administrators' costs and preferential debts (such as employee's wages up to an amount prescribed by statute). Furthermore, up to £600,000 of assets otherwise distributable to lenders with floating changes must be ring-fenced for distribution to unsecured creditors.
- Fixed charges require the lender to exercise absolute and unfettered dominion and control over the collateral which makes it impossible to take over certain classes of assets (e.g. inventory) and challenging to take over other classes of assets (e.g. receivables or bank accounts).

F. PRACTICAL COST CONSIDERATIONS

- Even if a lender can legally get a security interest, there are often logistical and cost considerations.
- In the U.K. if certain types of charges created by companies registered in England and Wales or Northern Ireland are not presented to the Registrar of Companies within 21 days after creation of the charges, together with a certified copy of the relevant instrument (if any) and a statement of the prescribed particulars and the fee, the charges will be void against any liquidator, administrator or creditor of the relevant company, unless an extension of the period for registration is obtained.
- In Mexico, all security documents are subject to local notarization, with notary fees often based on the amount of the guaranteed obligations, adding procedural delays and significant transaction costs.
- In the Netherlands, a lender will need works council approval.

G. ABILITY OF U.S. LENDER TO RECEIVE GUARANTEE

- U.S. lenders wishing to obtain guaranties from foreign subsidiaries should be aware of the local corporate benefit and financial assistance rules in the context of acquisition financing. The corporate benefit test is applied widely across jurisdictions, though different standards may apply to such evaluation.
- A German stock corporation (AG) must not grant financial assistance either in the form of a loan or credit support by way of a guarantee or other security for the purpose of acquiring its shares. As a consequence, a German obligor incorporated as a stock corporation (AG) is effectively prohibited from granting upstream or cross-stream security/guarantees (i.e. it can only secure its own debt and debt of its subsidiaries); and subsidiaries of such AG can grant upstream/cross-stream security for the debt of that AG and of other subsidiaries of that AG but not beyond.

G. ABILITY OF U.S. LENDER TO RECEIVE GUARANTEE

- In Belgium, the granting of such types of guarantees must form part of the corporate purpose (as set out in the articles of association of the Belgian entity) and be in the corporate interest of the guaranteeing company (a mere group interest is not sufficient). The corporate interest test is met when the guarantor itself derives a benefit from the transaction and the amount guaranteed is not disproportionate to the benefit derived or to the financial means available to the guarantor. Although the law does not require that the obligations of a company be limited to a percentage of its net assets, in practice, limitation language is often included.

G. ABILITY OF U.S. LENDER TO RECEIVE GUARANTEE (CON'T)

- Mexican subsidiaries may guarantee obligations of a U.S. borrower. It is important to confirm that the by-laws of such subsidiary expressly authorize it to guarantee third-party obligations. No "financial assistance rules" would apply under Mexican law
- Under English law, the board of directors an English company must act in the best interests of the company of which they are directors, for instance in the interests of its associated companies or the group of which it is a member as a whole. In essence, an upstream guarantee may be acceptable if the client's board of directors can honestly reach the conclusion that the giving of the guarantee will bring real benefit to the company or their actions are ratified by a resolution of all the shareholders of the company. Financial assistance is prohibited in circumstances where (1) a person is proposing to buy shares in a public company and financial assistance is given by that public company or one of its subsidiaries (whether public or private) or (2) a person is proposing to buy shares in a private company and financial assistance is given by a public subsidiary of that private company

G. ABILITY OF U.S. LENDER TO RECEIVE GUARANTEE (CON'T)

- Financial assistance rules in France prohibit French companies registered as SA (*société anonyme*) or SAS (*société par actions simplifiée*) from providing a guarantee/security in view of financing the acquisition of its own shares or the shares of other group members which are direct or indirect shareholders of the French company. There is no way to avoid such restrictions; the lending and the security structure of the acquisition must be fine-tuned to comply with this prohibition and criminal sanctions result if the prohibition is violated. Contracts entered into in violation of this principal may also be declared void.

H. THIN CAP RULES

- Although not strictly an obstacle to granting upstream credit support, thin capitalization rules may limit the deductibility of tax on interest incurred on debt of a foreign borrower that is guaranteed by related parties. Thin-capitalization rules are complex and expect local foreign tax advice should be in the context of any cross-border funding.
- In France, for example, to the extent that the debt of a French company is guaranteed by its subsidiaries, that debt is subject to thin capitalization limitations on interest deductibility, capped at the higher of 30% of taxable income and €3 million. Where the debt-to-equity ratio of the borrower is lower than 1.5:1.00, these thresholds are lowered to 10% and €1 million, respectively.
- In the UK, borrowers are subject to a corporate interest restriction, broadly limiting deductible interest to 30% of EBITDA, calculated in accordance with the UK tax code. Challenges to thin-capitalization brought by the UK revenue and customs department are based on transfer pricing rules. In Mexico, interest payments made by a Mexican resident company on a loan from a foreign related party are non-deductible if the debt-equity ratio exceeds 3:1.

I. RECOGNITION OF U.S. CHOICE OF LAW PROVISIONS AND ENFORCEMENT OF U.S. JUDGMENTS

- If you have a N.Y. law-governed pledge or guaranty, what do you need to consider to enforce your remedies under local law
- Generally, as a matter of private international law, foreign courts will enforce a choice of law provision, provided that it does not contradict mandatory rules of the relevant jurisdiction or is incompatible with public policy. However, this golden rule, established by the Rome Convention (article 3 section 1 of regulation (EC) no. 593/2008 (Rome I) a contract shall be governed by the law chosen by the parties), may have a more limited application in the context of secured transactions.

I. RECOGNITION OF U.S. CHOICE OF LAW PROVISIONS AND ENFORCEMENT OF U.S. JUDGMENTS (CON'T)

- Under French law security, as in most civil law countries, there is a distinction between the following:
  - personal guarantee (i.e. a commitment to pay the payment obligation of a third party) which may be governed (1) French law (and therefore can take the form of a guarantee (*cautionnement*) or a first demand guarantee (*garantie à première demande*) as set out above) or (2) by any other law, including N.Y. law provided that the borrower or the guarantor is a party to a facility agreement or a guarantee which is governed by such law; and
  - *in rem* security for which security agreements shall be governed by the law applicable to the jurisdiction where the assets/property granted as security are physically located (i.e. French law) (consistent with *lex rei sitae* principles applicable in many jurisdiction).

I. RECOGNITION OF U.S. CHOICE OF LAW PROVISIONS AND ENFORCEMENT OF U.S. JUDGMENTS (CON'T)

- The submission of the loan documentation (i.e. loan agreement and guarantee) to the jurisdiction of the New York State Court located in the city of New York would be valid and binding under French private international law if submission to N.Y. law is valid under N.Y. law and unless choice of N.Y. law is fraudulent. Certain mandatory French or European law rules (*lois de police*) may nevertheless apply despite the submission to New York law.
- As stated above, *in rem* security relating to assets located in France must be submitted to French law and to the jurisdiction of French courts pursuant to *lex rei sitae* principles and to the *lex fori*.

I. RECOGNITION OF U.S. CHOICE OF LAW PROVISIONS AND ENFORCEMENT OF U.S. JUDGMENTS (CON'T)

- An English court will not apply a chosen foreign law if (1) it is not pleaded and proved, (2) to do so would be contrary to the mandatory rules of English law or manifestly incompatible with English public policy, or (3) the choice is not valid under the chosen law.
- The judgment of a U.S. court with respect to N.Y. law-governed loan documents may or may not be enforced in the local jurisdiction.
  - In Australia, a judgment rendered by a U.S. court having jurisdiction recognized by an Australian court, for a readily calculable or fixed sum, would be recognized and enforced without a re-examination of the merits, subject to considerations of natural justice, public policy or fraud.

I. RECOGNITION OF U.S. CHOICE OF LAW PROVISIONS AND ENFORCEMENT OF U.S. JUDGMENTS (CON'T)

- In Belgium, prior to enforcing a foreign judgment, the courts will consider a multitude of factors, including whether (1) the judgment violates public policy or is irreconcilable with a Belgian precedent or a prior foreign judgment that is amendable to recognition in Belgium, or (2) if a claim in Belgium had been previously initiated between the same parties and is still pending.
- In China, a judgment rendered by a U.S. court will neither be recognized nor enforced because there is no bilateral judicial assistance treaty in place, or precedents of reciprocity,
- In England, a U.S. court judgment may be recognized according to common law principles and enforced by methods generally available for enforcement of English judgments.

J. AGENT OR TRUSTEE AS THE SECURED PARTY

- On U.S. syndicated deals, we are accustomed to the administrative or collateral agent holding security of the loan parties for the benefit of the secured lender group, and having the power to enforce such security on their behalf.
- Many common law jurisdictions such as England, Australia and Canada allow for agented syndicated deals.
- In Germany and Belgium, it is common to create a parallel debt structure for certain types of security, whereby the security agent is owed a “parallel” and equal debt to that owed to the secured parties. In Italy, parallel debt structures are not recognized and therefore the debt must be held directly by the creditor.
- The French Civil Code expressly allows security to be held by a security agent, however, this mechanism was recently introduced and therefore practitioners and French banks have not as yet adopted a unified standard for its application

K. WITHHOLDING TAX IMPLICATIONS

- Many foreign jurisdictions impose withholding tax on interest and fees paid by a foreign subsidiary in the relevant jurisdiction to U.S. lenders. The amount of such withholding tax may be reduced or eliminated where tax treaties exist between the U.S. and the relevant jurisdiction. For example, in Canada, a treaty was signed in 2007 to eliminate withholding taxes on non-related party interest expense.
- As a bank located and acting through the U.S. would generally not be subject to French withholding tax on interest payments based on French domestic law, no specific filings or prior authorization would be required to avail itself of the benefits of the double tax treaty between France and the U.S.

L. ANTI-MONEY LAUNDERING LAWS

- Originating loans to foreign entities MAY make a U.S. bank subject to local Anti-Money Laundering ("AML") or other Financial Crimes Compliance laws AND requirements (including sanctions and anti-corruption laws).
- According to the German Anti Money Laundering Act (Geldwäschegesetz - Section 2 para 1 No. 1), German branch offices (Zweigstellen/Zweigniederlassungen) of non-German credit institutions are subject to German AML compliance obligations when originating loans. Conversely, the origination of loans by non-German credit institutions not maintaining such German branches does not fall within the scope of German AML legislation.
- In Mexico, where a U.S. bank customarily grants loans to Mexican parties, Mexican AML requirements will need to be observed, including registration with the Vulnerable Activities Registry and filings of such activity with the Financial Intelligence Unit. Similarly in Italy, local AML law applies to non-E.U. banks authorized to operate in Italy without a branch.

M. PRIVACY/DATA CONCERNS

- Lending to corporate entities within the United Kingdom does not trigger the requirements of the General Data Protection Regulation ("GDPR") which applies to processing of data for individual data subjects within the E.U. only. If any guarantees for such lending were provided by individuals, the processing of that data would likely be subject to the GDPR which provides wide-ranging protections for and notifications to individual data subjects.

N. BANKRUPTCY AND CREDITORS RIGHTS

- The laws and proceedings of each foreign jurisdiction govern the types of enforcement actions and remedies that are available to lenders in an insolvency. Since insolvency laws are not standardized across borders, lenders need to be mindful of and assess such particularities with input from local foreign insolvency counsel ahead of taking guarantees and security in the relevant jurisdiction.
- In France, the order of priority of claims of creditors can vary depending on the insolvency procedure and the type of claim. Certain privileged creditors, including salaried employees and the tax administration rank ahead of secured creditors, and it is generally rare to see secured creditors recover significant portions of their claims. Furthermore, there is no established case law determining the validity of subordination and intercreditor agreements which could be successfully challenged in an insolvency context.

- *Any presentation by a Jones Day lawyer or employee should not be considered or construed as legal advice on any individual matter or circumstance. The contents of this document are intended for general information purposes only and may not be quoted or referred to in any other presentation, publication or proceeding without the prior written consent of Jones Day, which may be given or withheld at Jones Day's discretion. The distribution of this presentation or its content is not intended to create, and receipt of it does not constitute, an attorney-client relationship. The views set forth herein are the personal views of the authors and do not necessarily reflect those of Jones Day.*


JONES DAY
One Firm Worldwide℠